Amboy's In-Retirement Learning Center
INCOME

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Will You Outlive Your Money?

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Before you retire, take the time to figure out just how much money you'll need for retirement. One of the biggest concerns for retirees is whether their retirement savings will last the rest of their lives — will they run out of money? Social Security is not the guaranteed source of retirement income it once was, and people generally don't want to depend on public assistance or their children during their retirement years. Whether you might run out of money hinges upon several factors; how much money you've saved, how long you need your savings to last, and how quickly you spend your money, to name a few. You'll be better off if you can tackle these issues before retirement by maximizing your retirement nest egg. But, if you are entering retirement and you still have concerns about making your savings last, there are several steps you can take even at this late date. The following are tips and ideas to help make sure you don't outlive your money.

Tips to help make your savings last longer

You may be able to stretch your retirement savings by adjusting your spending habits. You might be able to get by with only minor changes to your spending habits, but if your retirement savings are far below your projected needs, drastic changes may be necessary. Saving even a little money can really add up if you do it consistently and earn a reasonable rate of return.

Make major changes to your spending patterns

If you have major concerns about running out of money, you may need to change your spending patterns drastically in order to make your savings last. The following are some suggested changes you may choose to implement:

- Consolidate any outstanding loans to reduce your interest rate or monthly payment. Consider using home equity financing for this purpose.
- If your home mortgage is paid in full, weigh the pros and cons of a reverse mortgage to increase your cash flow.
- Reduce your housing expenses by moving to a less expensive home or apartment.
- If you are still paying off your home mortgage, consider refinancing your mortgage if interest rates have dropped since you took the loan.
- Sell your second car, especially if it is only used occasionally.
- Shop around for less expensive insurance. You'd be amazed how much you can save in a year (and even more over a period of years) by switching to insurance policies that have lower premiums, but that still provide the coverage you need. Life and health insurance are the two areas where you probably stand to save the most, since premiums can go up dramatically with age and declining health. Consult your insurance professional.
- Have your child enroll in or transfer to a less expensive college (a state university as opposed to a private one, for example). This can be a particularly good idea if the cheaper college has a strong reputation and can provide a quality education. You could save significantly over the course of just two or three years.

Make minor changes to your spending patterns

Minor changes can also make a difference. You'd be surprised how quickly your savings add up when you implement a written budget and make several small changes to your spending patterns. If you have only minor concerns about making your retirement savings last, small changes to your spending habits may be enough to correct this problem. The following are several ideas you might consider when adjusting your spending patterns:

- Buy only the auto and homeowners insurance you really need. For example, consider canceling collision insurance on an older vehicle and self-insure instead. This may not save you a bundle, but every little bit helps. Of course, if you do have an accident, the amount you saved on your premium could be wiped out very quickly.
- Shop for the best interest rate whenever you need a loan.
- Switch to a lower interest credit card. Transfer your balances from higher interest cards and then cancel the old accounts.
- Eat dinner at home, and carry "brown-bag" lunches instead of eating out.
- Consider buying a well-maintained used car instead of a new car.

- Subscribe to the magazines and newspapers you read instead of paying full price at the newsstand.
- Where possible, cut down on utility costs and other household expenses.
- Get books and movies from your local library instead of buying or renting them.
- Plan your expenditures and avoid impulse buying.

Manage IRA distributions carefully

If you're trying to stretch your savings, you'll want to withdraw money from your IRA as slowly as possible. Not only will this conserve the principal balance, but it will also give your IRA funds the opportunity to continue growing tax deferred during your retirement years. However, bear in mind that you must start taking required minimum distributions (RMDs) from traditional IRAs (but not Roth IRAs) after age 70½. If you don't withdraw at least the required minimum, you'll be subject to a 50% tax on the difference.

Use caution when spending down your investment principal

Don't assume you'll be able to live on the earnings from your investment portfolio and your retirement account for the rest of your life. At some point, you will probably have to start drawing on the principal. You'll want to be careful not to spend too much too soon. This can be a great temptation particularly early in your retirement, because the tendency is to travel extensively and buy the things you couldn't afford during your working years. A good guideline is to make sure you don't spend more than 5% of your principal during the first five years of retirement. If you whittle away your principal too quickly, you won't be able to earn enough on the remaining principal to carry you through the later years.

Portfolio review

Your investment portfolio will likely be one of your major sources of retirement income. As such, it is important to make sure that your level of risk, your choice of investment vehicles, and your asset allocation are appropriate considering your long-term objectives. While you don't want to lose your investment principal, you also don't want to lose out to inflation. A review of your investment portfolio is essential in evaluating the lasting potential of your nest egg.

Continue to invest for growth

Traditional wisdom holds that retirees should value the safety of their principal above all else. For this reason, some people shift all of their investment portfolio to fixed-income investments, such as bonds and money market accounts, as they approach retirement. The problem with this approach is that it completely ignores the effects of inflation. You will actually lose money if the return on your investments does not keep up with inflation. The allocation of your portfolio should generally become progressively more conservative as you grow older, but it is wise to consider maintaining at least a portion of your portfolio in growth investments. Many financial professionals recommend that you follow this simple guideline: The percentage of stocks or stock mutual funds in your portfolio should equal approximately 100% minus your age. So, for example, at age 60 your portfolio might contain 40% stocks and stock funds (100% - 60% = 40%). Obviously, how you apply this guideline depends on your risk tolerance and other personal factors.

Basic rules of investment still apply during retirement

Although you will undoubtedly make changes to your investment portfolio as you reach retirement age, you should still bear in mind the basic rules of investing. Diversification and asset allocation remain important as you make the transition from accumulation to utilization.

Caution: *Asset allocation and diversification cannot guarantee a profit or insure against a loss. There is no guarantee that any investment strategy will be successful; all investing involves risk, including the possible loss of principal*

Laddering investments

Laddering is a method of staggering the maturities of your investments so that they don't all mature at the same time. You can apply laddering to any type of deposit, loan, or security having a specified maturity date, such as bonds.

Laddering can reduce interest rate risk

Interest rates rise and fall in response to many factors. Consequently, they are largely unpredictable. Whether you apply laddering to a cash reserve or use it in portfolio investing, minimizing interest rate risk is one of its most important benefits. Laddering investments minimizes interest rate risk because you will be investing at various times and under various interest rates. Thus, you are unlikely to be consistently locked into lower-than-market interest rates.

A single large deposit or investment that matures during an interest rate slump will leave you with two undesirable choices regarding reinvestment. You can hold the money in a low-interest savings account until rates improve or roll it over at the current low rate. However, a later rebound of interest rates can catch you locked into the prior low rate for an extended period. Breaking your investment into smaller pieces and laddering maturity dates allows you to avoid this situation.

How do you do it?

When you first begin your laddering strategy, you will need to acquire several term deposits (e.g., certificates of deposit) or securities with specified maturity dates. Initially, your individual investments should have terms of varying lengths, and you should intend to hold them until maturity. This will set up your staggered maturity dates. For example, you might purchase three separate certificates of deposit — one with a three-month term, one with a six-month term, and one with a nine-month term. When you reinvest as your CDs mature, your new investments should each be of the same length to perpetuate the staggering, or laddering, of maturity dates. Keep your laddering strategy intact by promptly redepositing each maturing investment for a new term.

Long-term care insurance

A catastrophic injury or debilitating disease that requires you to enter a nursing home can destroy your best-laid financial plans. You will need to decide whether to take out a long-term care insurance policy that may cover nursing home care, home health care, adult day care, respite care, and residential care. If you decide to purchase such a policy, you'll need to choose the best time to do so. Typically, unless you have a chronic condition that makes you more likely to require long-term care, there is generally no reason to begin thinking about this issue before age 50. Usually, there is no reason to purchase such a policy before age 60.

Won't Medicare pay for any long-term care expenses you might incur?

Contrary to popular belief, Medicare will not pay for most long-term care expenses, and neither will any health insurance you may have through your employer. Medicare benefits are only available if you enter a nursing home within 30 days after a hospital stay of three days or more. Even then, Medicare typically will only provide full coverage for 20 days of skilled nursing home care in Medicare-approved facilities. After 20 days, Medicare will cover part of the cost of care. You will pay $167.50 per day in 2018, and Medicare will cover the rest through day 100. No further coverage is available after 100 days.

What about Medicaid?

Medicaid is sponsored jointly by federal and state governments. Each state's Medicaid program is required to provide certain minimum medical benefits to qualified persons, including inpatient hospital services, nursing home care, and physicians' services. States also have the option of providing additional services. All states require proof of financial need. However, each state has different rules regarding benefits and eligibility, so it is essential that you understand your state's Medicaid program before you decide that Medicaid will provide adequate long-term care coverage.

How much does long-term care insurance cost?

Unfortunately, long-term care insurance can be quite expensive. If you begin coverage when you are younger, premiums will be more reasonable, but you will likely be paying for the insurance for a much longer period of time. The cost of LTCI will vary depending on your age, the benefits, and the insurer you choose.

Estimating Your Retirement Income Needs

You know how important it is to plan for your retirement, but where do you begin? One of your first steps should be to estimate how much income you'll need to fund your retirement. That's not as easy as it sounds, because retirement planning is not an exact science. Your specific needs depend on your goals and many other factors.

Use your current income as a starting point

It's common to discuss desired annual retirement income as a percentage of your current income. Depending on who you're talking to, that percentage could be anywhere from 60% to 90%, or even more. The appeal of this approach lies in its simplicity, and the fact that there's a fairly common-sense analysis underlying it: Your current income sustains your present lifestyle, so taking that income and reducing it by a specific percentage to reflect the fact that there will be certain expenses you'll no longer be liable for (e.g., payroll taxes) will, theoretically, allow you to sustain your current lifestyle.

The problem with this approach is that it doesn't account for your specific situation. If you intend to travel extensively in retirement, for example, you might easily need 100% (or more) of your current income to get by. It's fine to use a percentage of your current income as a benchmark, but it's worth going through all of your current expenses in detail, and really thinking about how those expenses will change over time as you transition into retirement.

Project your retirement expenses

Your annual income during retirement should be enough (or more than enough) to meet your retirement expenses. That's why estimating those expenses is a big piece of the retirement planning puzzle. But you may have a hard time identifying all of your expenses and projecting how much you'll be spending in each area, especially if retirement is still far off. To help you get started, here are some common retirement expenses:

- Food and clothing
- Housing: Rent or mortgage payments, property taxes, homeowners insurance, property upkeep and repairs
- Utilities: Gas, electric, water, telephone, cable TV
- Transportation: Car payments, auto insurance, gas, maintenance and repairs, public transportation
- Insurance: Medical, dental, life, disability, long-term care
- Health-care costs not covered by insurance: Deductibles, co-payments, prescription drugs
- Taxes: Federal and state income tax, capital gains tax

- Debts: Personal loans, business loans, credit card payments
- Education: Children's or grandchildren's college expenses
- Gifts: Charitable and personal
- Savings and investments: Contributions to IRAs, annuities, and other investment accounts
- Recreation: Travel, dining out, hobbies, leisure activities
- Care for yourself, your parents, or others: Costs for a nursing home, home health aide, or other type of assisted living
- Miscellaneous: Personal grooming, pets, club memberships

Don't forget that the cost of living will go up over time. The average annual rate of inflation over the past 20 years has been approximately 2%.[1] And keep in mind that your retirement expenses may change from year to year. For example, you may pay off your home mortgage or your children's education early in retirement. Other expenses, such as health care and insurance, may increase as you age. To protect against these variables, build a comfortable cushion into your estimates (it's always best to be conservative). Finally, have a financial professional help you with your estimates to make sure they're as accurate and realistic as possible.

Decide when you'll retire

To determine your total retirement needs, you can't just estimate how much annual income you need. You also have to estimate how long you'll be retired. Why? The longer your retirement, the more years of income you'll need to fund it. The length of your retirement will depend partly on when you plan to retire. This important decision typically revolves around your personal goals and financial situation. For example, you may see yourself retiring at 50 to get the most out of your retirement. Maybe a booming stock market or a generous early retirement package will make that possible. Although it's great to have the flexibility to choose when you'll retire, it's important to remember that retiring at 50 will end up costing you a lot more than retiring at 65.

Estimate your life expectancy

The age at which you retire isn't the only factor that determines how long you'll be retired. The other important factor is your lifespan. We all hope to live to an old age, but a longer life means that you'll have even more years of retirement to fund. You may even run the risk of outliving your savings and other income sources. To guard against that risk, you'll need to estimate your life expectancy. You can use government statistics, life insurance tables, or a life expectancy calculator to get a reasonable estimate of how long you'll live. Experts base these estimates on your age, gender, race, health, lifestyle, occupation, and family history. But remember, these are just estimates. There's no way to predict how long you'll actually live, but with life expectancies on the rise, it's probably best to assume you'll live longer than you expect.

Identify your sources of retirement income

Once you have an idea of your retirement income needs, your next step is to assess how prepared you are to meet those needs. In other words, what sources of retirement income will be available to you? Your employer may offer a traditional pension that will pay you monthly benefits. In addition, you can likely count on Social Security to provide a portion of your retirement income. To get an estimate of your Social Security benefits, visit the Social Security Administration website (www.ssa.gov). Additional sources of retirement income may include a 401(k) or other retirement plan, IRAs, annuities, and other investments. The amount of income you receive from those sources will depend on the amount you invest, the rate of investment return, and other factors. Finally, if you plan to work during retirement, your job earnings will be another source of income.

Make up any income shortfall

If you're lucky, your expected income sources will be more than enough to fund even a lengthy retirement. But what if it looks like you'll come up short? Don't panic — there are probably steps that you can take to bridge the gap. A financial professional can help you figure out the best ways to do that, but here are a few suggestions:

- Try to cut current expenses so you'll have more money to save for retirement
- Shift your assets to investments that have the potential to substantially outpace inflation (but keep in mind that investments that offer higher potential returns may involve greater risk of loss)
- Lower your expectations for retirement so you won't need as much money (no beach house on the Riviera, for example)
- Work part-time during retirement for extra income
- Consider delaying your retirement for a few years (or longer)

[1] Calculated form Consumer Price Index (CPI-U) data published by the Bureau of Labor Statistics, January 2018

Asset Allocation: Projecting a Glide Path

Asset allocation in retirement

The classic image of retirement investing is that of a retiree putting 100 percent of his or her assets into bonds and clipping coupons from those bonds for income payments. That image goes back to when bondholders had to physically cut coupons off of bond documents and submit them to the issuer to receive the interest that a bond paid.

Just as the days of clipping coupons are long gone, so is the idea that bonds alone constitute a complete retirement investing strategy. Asset allocation--the process of dividing up your portfolio among stocks, bonds, cash, and possibly other types of investments--accounts for most of the ups and downs of a portfolio's returns. That's just as true for your retirement portfolio as it was during the years you've spent trying to build those assets. That means the need for proper asset allocation doesn't stop when you retire. After all, it's possible you could spend roughly as long tapping your nest egg as you've spent creating it.

However, an asset allocation strategy for your portfolio in retirement may be somewhat different from the one you used when saving for retirement. During the accumulation years, you may have made fewer demands on your portfolio. Your task was relatively simple: try to increase the value of your nest egg while minimizing the risk you took trying to reach your savings goal. As a result, your asset allocation may have been focused on long-term growth.

But when you reach retirement, your priorities for and demands on your portfolio are likely to be somewhat different. For example, when you were saving, you may have focused on average annual returns; as long as you were earning an acceptable average return, you may have been happy. However, if you're now planning to rely on your savings to produce an income, the consistency of year-to-year returns and your portfolio's volatility may assume greater importance.

Balancing the need for both immediate income and long-term returns can be a challenge. Invest too conservatively, and your portfolio may not be able to grow enough to maintain your standard of living. Invest too aggressively, and you could find yourself having to withdraw money or sell securities at an inopportune time, jeopardizing future income and undercutting your long-term retirement income plan. Like Goldilocks, you want to get it just right.

One of the many reasons long-term asset allocation planning in retirement is important is that you may have less time to recover from a market downturn. When you're saving for retirement, you may be able to offset the impact of a loss by increasing the amount you save, or simply waiting for a turnaround. If you're relying on the proceeds of your asset allocation process to provide you with living expenses--whether day-to-day, predictable ones, or unexpected life events--you may have less flexibility to adjust your asset allocation to cope with market fluctuations. A market loss that's disturbing when you're years from retirement can be devastating if it occurs when you're on the verge of retiring or recently retired. Asset allocation alone does not guarantee a profit or ensure against a loss, but it can help you manage the level and types of risk you take with your investments based on your specific needs.

In retirement, your asset allocation may need some alterations to ensure that it:

- Provides ongoing income needed to pay expenses
- Minimizes volatility to assure both reliable current income and the ability to provide income in the future
- Maximizes the likelihood that your portfolio will last as long as you need it to
- Keeps pace with inflation in order to maintain purchasing power over time

Caution: *Asset allocation and diversification cannot guarantee a profit or insure against a loss. There is no guarantee that any investment strategy will be successful; all investing involves risk, including the possible loss of principal.*

Why income alone isn't enough

Retirees who put all their investments into bonds when they retire often find after a few years that doing so doesn't account for the impact of inflation. The need to outpace inflation doesn't end at retirement; in fact, it becomes even more important. In putting together a retirement income plan, you need to make sure your asset allocation strategy takes inflation into account. Otherwise, you may have less buying power in the later years of your retirement because your income doesn't stretch as far. The biggest problem with inflation in retirement is not its immediate impact but its effects over time. Because of inflation, each dollar you've saved will buy less and less as time goes on. At three percent annual inflation, something that costs $100 today would cost $181 in 20 years.

Inflation also has an impact on your net investment returns. Let's say your money is earning four percent. If inflation is running between three to four percent (its historical average), your real return is only one percent at best--and that's before subtracting any account fees, taxes, or other expenses.

That means that retiring is no reason to turn your back on growth-oriented investments. Though past performance is no guarantee of future results, stocks historically have had better long-term returns than bonds or cash. Keeping a portion of your investments invested for growth (generally the role of stocks in a portfolio) gives you the potential for higher returns that can help you at least keep pace with inflation. The tradeoff: equities also generally involve more volatility and risk of loss than income-oriented investments. Effective diversification among various types of investments can help you balance lower-yielding, relatively safe choices that can provide predictable income or preserve capital with those that may be volatile but that offer potential for higher returns.

There are other reasons not to focus exclusively on income investments in retirement. Interest rate risk is one of them. Some retirees are surprised to learn that even though a bond's interest rate may be fixed, bond prices can go up and down (though typically not as much as those of stocks). When interest rates rise, bond prices typically fall. That may not matter if you hold a bond to maturity, but if you must sell a bond before it matures, you could get less than you paid for it. Also, if you hold individual bonds or Certificates of Deposit, and interest rates fall before that investment matures, you may not be able to get the same interest rate if you try to reinvest that money. That could, in turn, affect your income.

Just as your time horizon should influence your asset allocation during your saving years, it also is a factor during the distribution years. The longer you expect to spend in retirement--for example, if you plan to retire early, or have a family history of longevity--the greater the percentage of equities you may need in your portfolio. However, as mentioned previously, having a greater percentage of equities also could increase your portfolio's volatility. A higher equity allocation also might mean a greater possibility of having to liquidate at least some of those assets to meet your income needs. Striking the right balance over time between predictable income, capital preservation, portfolio volatility, portfolio longevity, and the need to maintain purchasing power is the role of a glide path.

What is a glide path?

An equity glide path refers to the process of gradually, methodically adjusting a portfolio over time, generally by reducing the percentage devoted to equities in order to make it more conservative as the portfolio draws closer to a given date. In a way, the glide path resembles that of an airplane as it heads for a landing; your portfolio's glide path attempts to ensure that you reach your goal without stopping short before the end of the runway. As you were saving for retirement, did you become more conservative with your investments as you've gotten closer to retirement? If so, you've had a glide path without even realizing it.

A glide path can apply to any investment portfolio that is managed with a time frame in mind. It's easy to see why a glide path might be important in retirement. As you age and continue to tap your retirement assets, your financial and psychological ability to tolerate risk may be reduced over time; that has implications for the role of equities in your portfolio.

The concept of a glide path is the foundation of so-called lifecycle or target-date mutual funds. For example, a lifecycle fund relies on a glide path to determine how its asset allocation changes over time as the fund gets closer to its specific target date. Funds designed to provide a specific systematic payment over a given time period--for example, those aimed at providing retirement income--also base decisions on a chosen glide path, though the strategy used may be different from that of a fund focused on accumulating assets.

Tip: *Remember that each such fund has a unique way of applying a glide path. Before investing in a mutual fund, obtain and read its prospectus (which is available from the fund) so you can carefully consider its investment objectives, risks, charges, and expenses before investing.*

A glide path may apply not only to shifting percentages among the three major asset classes--stock, bonds, and cash--but also to specific sectors. For example, a glide path might gradually reduce the percentage of the stock portfolio that is devoted to riskier types of stocks, such as small-cap stocks or emerging-market stocks, and concentrate on larger, well-established domestic companies in an attempt to reduce the portfolio's volatility. It might even eventually eliminate certain asset classes entirely in the portfolio's later years.

Timing is key

Volatility is just as critical in retirement as it is when you're accumulating savings--perhaps even more so. Why? Because if stocks must be sold at a reduced price during a down market to help pay expenses, that loss represents reduced future earnings power that can be difficult to replace.

The timing of market volatility can have a profound impact on a portfolio's longevity. Negative returns during the early retirement years have more impact on the likelihood of a portfolio's sustainability than they do later in retirement; conversely, consistent above-average returns early in retirement can substantially minimize the chances of running out of money too early. When multiplied by the miracle of compound interest, higher early returns can lead to a higher overall retirement nest egg. (However, bear in mind that to try for higher returns, you may take on greater risk, which also could increase the chance of a loss, thereby bringing on precisely the opposite result of what you're hoping for.)

That's why a glide path takes volatility into account in establishing and adjusting a target asset allocation over time. However, the way a portfolio is managed at the beginning of its time frame is not the only important factor. The end of the designated time frame is also important, and there are different approaches for dealing with a glide path's final years. For example, some portfolio managers continue to adjust a portfolio's asset allocation even after a particular target date is reached. Others prefer to leave the relative weightings among asset classes fairly constant once the target date is reached. The difference between the two approaches can be significant, especially for a married couple who must consider how to address the income needs of a surviving spouse.

Your asset allocation also may be affected by other retirement-related decisions. For example, if you plan to continue to work part time in retirement, those earnings could help compensate for fluctuating income from a more volatile asset allocation strategy, or cushion the impact of a market downturn early in retirement. Anticipating a sudden influx of money--for example, an inheritance--might also change your perspective on your projected glide path.

Examples of asset allocation and glide path strategies

Your individual strategy will need to be tailored to your own situation and needs, but the following represent some hypothetical examples of various ways to manage asset allocation in retirement. Bear in mind that all investing involves risk, including the possible loss of principal, and there can be no guarantee that any investing strategy will be successful.

- Static asset allocation: In some cases, a glide path may be essentially flat. An initial asset allocation is set, then rebalanced periodically to maintain the relative weightings of various types of investments from year to year.
- Tactical asset allocation: A portfolio that shifts its asset allocation based on projected market conditions may have no firm glide path at all. In some cases, a portfolio manager may combine approaches by establishing a core asset allocation or glide path while using tactical asset allocation for a portion of the portfolio.
- Fixed decreases over time in the percentage of equity investments: This approach gradually reduces the investment in equities by a given percentage at regular intervals. For example, a hypothetical retiree might reduce the equity allotment by two percent each year, or five percent every five years.
- Accelerating decreases in the equity portion during the later retirement years: This approach not only would make a portfolio more conservative as the retiree ages; it would gradually speed up the process of doing so. The older the retiree, the more rapidly the equity portion is reduced. ***Example(s):*** *When John retires, he initially decides to reduce the equities portion of his portfolio by two percent every five years. After he reaches a certain age, he accelerates the process of making his portfolio more conservative by increasing the percentages he shifts out of equities and into other asset classes. He decides to start cutting his equity allocation by four percent every other year, and to go even further by cutting seven percent from his equity allocation each year once he's been retired for 20 years.*
- Slowing the process of reducing equity allocations in later retirement years: This is the opposite of the above strategy. Instead of gradually increasing the rate at which equities are reduced, this strategy instead continues to reduce equity investments, but at a slower pace. A similar approach is often used by target-date mutual funds. ***Example(s):*** *When she retires at age 62, Jane begins to reduce her equity allocation by six percent every five years. After 15 years, she is concerned that if she continues at that pace, her portfolio eventually might not be able to maintain her standard of living in later years. She continues to reduce her equity investments, but now cuts it by only four percent every five years, eventually bringing down the percentage shifted out of equities to one percent every other year.*

Glide paths, sustainability, and withdrawal rates

Your glide path strategy will affect your portfolio's returns, the amount available for living expenses, and the probability that the portfolio will last throughout the projected time frame. One study of various distribution glide path strategies for retirement portfolios ("Dynamic Allocation Strategies for Distribution Portfolios: Determining the Optimal Distribution Glide Path," by David M. Blanchett, *Journal of Financial Planning* , December 2007) indicated that the shorter the withdrawal period and the lower the withdrawal rate, the less impact asset allocation had on the results. However, the longer the withdrawal period and the higher the withdrawal rate, the more critical asset allocation and the chosen glide path became to the portfolio's chances of lasting. In most cases, the study indicated, a static asset allocation was effective; however, reducing the equity portion more rapidly as time goes on also had a high probability of success.

Bear in mind that the study was based on historical returns for those asset classes, and there's no guarantee that future returns would yield the same results. Also, the study was not intended as financial advice. No one glide path is appropriate for everyone. An asset allocation strategy that might be highly suitable for someone with a ten-year time frame might have a much lower probability of success over a longer period. And even if a given glide path produces higher long-term returns, it may not be sustainable if the portfolio is too volatile for your individual comfort level, or cannot produce an income that's reliable enough from year to year to cover needed expenses. Any projected glide path should take into account your ability to implement that strategy and stick to it over the long term.

Though a retirement portfolio's glide path and its withdrawal rate are different, the two are interdependent. The higher a withdrawal rate, the greater the challenge of creating an asset allocation that can produce a return high enough to sustain those withdrawals. That in turn will affect your asset allocation. Similarly, a portfolio's glide path will affect its level of volatility and overall returns over time, which in turn can affect how sustainable a given withdrawal rate is. Constructed properly, a glide path should enable you to establish a sustainable withdrawal rate that will minimize the portfolio's chances of being exhausted prematurely.

Estimating rates of return for various asset classes

Constructing a glide path that will produce the needed annual return requires making some assumptions about returns for various asset classes. As seen above, those assumptions typically rely on historical rates of return for the major asset classes, such as stocks, bonds, and cash, as well as for subcategories within each class. However, the phrase "past performance is no guarantee of future results" is especially applicable when it comes to asset allocation in retirement. If your investment returns are forecast based on a recent period when stocks have been particularly buoyant, assuming those returns will continue could lead to an asset allocation strategy and withdrawal rate in the early years of retirement that is overly optimistic and not sustainable if returns return to normal or fall below their historical averages. Also, projecting returns based on too short a time frame could lead to estimates that are either too positive or too negative.

Nearing Retirement/Retirement Checklist

General information	Yes	No	N/A
1. Has relevant personal information been gathered? • Age • Age of spouse or partner • Number of minor children and their ages	❑	❑	❑
2. Has financial situation been assessed? • Estimated annual expenses during retirement • Estimated annual income during retirement (pretax and after-tax) • Total assets and savings to date • Total retirement savings to date • Estimated yearly contribution to retirement savings • Total liabilities to date • Income tax bracket and filing status • Health insurance coverage for each spouse • Long-term care insurance coverage for each spouse • Life insurance coverage for each spouse • Wills, durable power of attorney, health-care proxy, and other estate planning information • Beneficiary designations	❑	❑	❑
Notes:			
Determining retirement income needs	**Yes**	**No**	**N/A**
1. Has life expectancy been estimated to project how long retirement will last?	❑	❑	❑
2. Have clear goals and objectives been established for retirement?	❑	❑	❑
3. Have other major financial goals been funded or achieved? • Pay off home mortgage • Fund children's education • Buy retirement home • Other	❑	❑	❑
4. If not, have those other goals been prioritized with retirement goals?	❑	❑	❑
5. Have annual retirement expenses been estimated, keeping in mind that those expenses may change from year to year? • Food, clothing, housing • Insurance • Health care • Travel and recreation • Other	❑	❑	❑

6. Have annual retirement income needs been estimated, based on the preceding goals and expenses?	❑	❑	❑
7. Has expected annual income been estimated, and will that income be sufficient to meet retirement needs? • Social Security • Pensions • Savings and investments (including IRAs and retirement plans) • Job earnings • Other	❑	❑	❑
8. If not, are there steps that can be taken to bridge the gap? • Work part-time • Cut expenses • Set more modest goals • Delay retirement • Other	❑	❑	❑
9. Have inflation, taxes, and conservative rates of return been factored into these estimates?	❑	❑	❑
Notes:			
Employer-sponsored retirement plans and IRAs	**Yes**	**No**	**N/A**
1. Is a 401(k) or other employer-sponsored retirement plan funded?	❑	❑	❑
2. Is an IRA in place? • Roth IRAs • Traditional IRAs	❑	❑	❑
3. Are the tax issues associated with taking distributions from IRAs and employer-sponsored plans understood?	❑	❑	❑
4. Has leaving money in these retirement accounts as long as possible to defer taxes and prolong tax-deferred growth been considered?	❑	❑	❑
Notes:			
Annuities and other savings tools	**Yes**	**No**	**N/A**
1. Are there annuities, or has thought been given to purchasing annuities?	❑	❑	❑
2. If so, is the taxation of annuities and the payout options available understood?	❑	❑	❑

3. Have a payout option and payment beginning date been chosen?	❑	❑	❑
4. Are there other savings tools owned, whether part of the retirement portfolio or not? • Cash value life insurance • Mutual funds • Stocks and bonds • CDs • Other	❑	❑	❑
5. If so, are the tax issues surrounding these tools understood?	❑	❑	❑
Notes:			

Investment planning	Yes	No	N/A
1. Now that retirement is here (or near), have plans been made to change how the retirement portfolio and other assets are invested?	❑	❑	❑
2. Will the client/advisor monitor the retirement portfolio and other investments throughout retirement and make changes when appropriate?	❑	❑	❑
3. Have expectations been established for how the retirement portfolio and other investments will perform in the coming years?	❑	❑	❑
4. Is some degree of investment risk acceptable to the client?	❑	❑	❑
5. Has a distribution strategy been discussed/developed?	❑	❑	❑
Notes:			

Insurance planning	Yes	No	N/A
1. If under age 65, will adequate health insurance be available until Medicare eligibility is established?	❑	❑	❑
2. If 65 or older, has a Medigap or other health policy been purchased to supplement Medicare, or is employer-sponsored coverage available?	❑	❑	❑
3. Is there long-term care insurance, or have this and other strategies been considered to protect against the cost of nursing home care?	❑	❑	❑
4. Have life insurance needs been revisited?	❑	❑	❑
5. Have other types of insurance coverage been reviewed? • Auto and homeowners • Disability (will end at retirement) • Liability • Other	❑	❑	❑

Notes:			

Estate planning	**Yes**	**No**	**N/A**
1. Will beneficiary designations be reviewed periodically? • Employer-sponsored plans • IRAs • Annuities • Life insurance • Other	❑	❑	❑
2. Has will been reviewed/updated?	❑	❑	❑
3. Is there a durable power of attorney or health-care proxy?	❑	❑	❑
4. Have other estate planning tools and strategies been considered? • Trusts • Gifting assets • Durable power of attorneys • Advanced medical directives • Other	❑	❑	❑
Notes:			

Annuities and Retirement Planning

You may have heard that IRAs and employer-sponsored plans (e.g., 401(k)s) are the best ways to invest for retirement. That's true for many people, but what if you've maxed out your contributions to those accounts and want to save more? An annuity may be a good investment to look into.

Get the lay of the land

An annuity is a tax-deferred insurance contract. The details on how it works vary, but here's the general idea. You invest your money (either a lump sum or a series of contributions) with a life insurance company that sells annuities (the annuity issuer). The period when you are funding the annuity is known as the accumulation phase. In exchange for your investment, the annuity issuer promises to make payments to you or a named beneficiary at some point in the future. The period when you are receiving payments from the annuity is known as the distribution phase. Chances are, you'll start receiving payments after you retire. Annuities may be subject to certain charges and expenses, including mortality charges, surrender charges, administrative fees, and other charges.

Understand your payout options

Understanding your annuity payout options is very important. Keep in mind that payments are based on the claims-paying ability of the issuer. You want to be sure that the payments you receive will meet your income needs during retirement. Here are some of the most common payout options:

- You surrender the annuity and receive a lump-sum payment of all of the money you have accumulated.
- You receive payments from the annuity over a specific number of years, typically between 5 and 20. If you die before this "period certain" is up, your beneficiary will receive the remaining payments.
- You receive payments from the annuity for your entire lifetime. You can't outlive the payments (no matter how long you live), but there will typically be no survivor payments after you die.
- You combine a lifetime annuity with a period certain annuity. This means that you receive payments for the longer of your lifetime or the time period chosen. Again, if you die before the period certain is up, your beneficiary will receive the remaining payments.
- You elect a joint and survivor annuity so that payments last for the combined life of you and another person, usually your spouse. When one of you dies, the survivor receives payments for the rest of his or her life.

When you surrender the annuity for a lump sum, your tax bill on the investment earnings will be due all in one year. The other options on this list provide you with a guaranteed stream of income (subject to the claims-paying ability of the issuer). They're known as annuitization options because you've elected to spread payments over a period of years. Part of each payment is a return of your principal investment. The other part is taxable investment earnings. You typically receive payments at regular intervals throughout the year (usually monthly, but sometimes quarterly or yearly). The amount of each payment depends on the amount of your principal investment, the particular type of annuity, your selected payout option, the length of the payout period, and your age if payments are to be made over your lifetime.

Consider the pros and cons

An annuity can often be a great addition to your retirement portfolio. Here are some reasons to consider investing in an annuity:

- Your investment earnings are tax deferred as long as they remain in the annuity. You don't pay income tax on those earnings until they are paid out to you.
- An annuity may be free from the claims of your creditors in some states.
- If you die with an annuity, the annuity's death benefit will pass to your beneficiary without having to go through probate.
- Your annuity can be a reliable source of retirement income, and you have some freedom to decide how you'll receive that income.
- You don't have to meet income tests or other criteria to invest in an annuity.
- You're not subject to an annual contribution limit, unlike IRAs and employer-sponsored plans. You can contribute as much or as little as you like in any given year.
- You're not required to start taking distributions from an annuity at age 70½ (the required minimum distribution age for IRAs and employer-sponsored plans). You can typically postpone payments until you need the income.

But annuities aren't for everyone. Here are some potential drawbacks:

- Contributions to nonqualified annuities are made with after-tax dollars and are not tax deductible.
- Once you've elected to annuitize payments, you usually can't change them, but there are some exceptions.
- You can take your money from an annuity before you start receiving payments, but your annuity issuer may impose a surrender charge if you withdraw your money within a certain number of years (e.g., seven) after your original investment.
- You may have to pay other costs when you invest in an annuity (e.g., annual fees, investment management fees, insurance expenses).
- You may be subject to a 10 percent federal penalty tax (in addition to any regular income tax) if you withdraw earnings from an annuity before age 59½, unless you meet one of the exceptions to this rule.
- Investment gains are taxed at ordinary income tax rates, not at the lower capital gains rate.

Choose the right type of annuity

If you think that an annuity is right for you, your next step is to decide which type of annuity. Overwhelmed by all of the annuity products on the market today? Don't be. In fact, most annuities fit into a small handful of categories. Your choices basically revolve around two key questions.

First, how soon would you like annuity payments to begin? That probably depends on how close you are to retiring. If you're near retirement or already retired, an immediate annuity may be your best bet. This type of annuity starts making payments to you shortly after you buy the annuity, typically within a year or less. But what if you're younger, and retirement is still a long-term goal? Then you're probably better off with a deferred annuity. As the name suggests, this type of annuity lets you postpone payments until a later time, even if that's many years down the road.

Second, how would you like your money invested? With a fixed annuity, the annuity issuer determines an interest rate to credit to your investment account. An immediate fixed annuity guarantees a particular rate, and your payment amount never varies. A deferred fixed annuity guarantees your rate for a certain number of years; your rate then fluctuates from year to year as market interest rates change. A variable annuity, whether immediate or deferred, gives you more control and the chance to earn a better rate of return (although with a greater potential for gain comes a greater potential for loss of principal). You select your own investments from the subaccounts that the annuity issuer offers. Your payment amount will vary based on how your investments perform.

Note: *Variable annuities are long-term investments suitable for retirement funding and are subject to market fluctuations and investment risk including the possibility of loss of principal. Variable annuities contain fees and charges including, but not limited to mortality and expense risk charges, sales and surrender (early withdrawal) charges, administrative fees and charges for optional benefits and riders.*

Variable annuities are sold by prospectus. You should consider the investment objectives, risk, charges and expenses

carefully before investing. The prospectus, which contains this and other information about the variable annuity, can be obtained from the insurance company issuing the variable annuity or from your financial professional. You should read the prospectus carefully before you invest.

Shop around

It pays to shop around for the right annuity. In fact, doing a little homework could save you hundreds of dollars a year or more. Why? Rates of return and costs can vary widely between different annuities. You'll also want to shop around for a reputable, financially sound annuity issuer. There are firms that make a business of rating insurance companies based on their financial strength, investment performance, and other factors. Consider checking out these ratings.

Sustainable Withdrawal Rates

What is a sustainable withdrawal rate?

A withdrawal rate is the percentage that is withdrawn each year from an investment portfolio. If you take $20,000 from a $1 million portfolio, your withdrawal rate that year is two percent ($20,000 divided by $1 million).

However, in retirement income planning, what's important is not just your withdrawal rate, but your sustainable withdrawal rate. A sustainable withdrawal rate represents the maximum percentage that can be withdrawn from an investment portfolio each year to provide income with reasonable certainty that the income provided can be sustained as long as it's needed (for example, throughout your lifetime).

Why is having a sustainable withdrawal rate important?

Your retirement lifestyle will depend not only on your assets and investment choices, but also on how quickly you draw down your retirement portfolio. Figuring out an appropriate withdrawal rate is a key factor in retirement planning. However, this presents many challenges and requires multifaceted analysis of many aspects of your retirement income plan. After all, it's getting more and more common for retirement to last 30 years or more, and a lot can happen during that time. Drawing too heavily on your investment portfolio, especially in the early years, could mean running out of money too soon. Take too little, and you might needlessly deny yourself the ability to enjoy your money. You want to find a rate of withdrawal that gives you the best chance to maximize income over your entire retirement period.

A sustainable withdrawal rate is critical to retirement planning, but it can apply to any investment portfolio that is managed with a defined time frame in mind. It's also fundamental to certain types of mutual funds that are managed to provide regular payments over a specific time period. For example, some so-called distribution funds, which are often used to provide retirees with ongoing income, are designed to distribute all of an investor's assets by the time the fund reaches its targeted time horizon. As a result, the fund must calculate how much money can be distributed from the fund each year without exhausting its resources before that target date is reached.

Tip: *Each distribution fund has a unique way of addressing the question of a sustainable withdrawal rate. Before investing in one, obtain its prospectus (available from the fund), and read it so you can carefully consider its investment objectives, risks, charges, and expenses before investing.*

How does a sustainable withdrawal rate work?

Perhaps the most well-known approach is to withdraw a specific percentage of your portfolio each year. In order to be sustainable, the percentage must be based on assumptions about the future, such as how long you'll need your portfolio to last, your rate of return, and other factors. It also must take into account the effect of inflation.

Example(s): *John has a $2 million portfolio when he retires. He estimates that withdrawing $80,000 a year (adjusted for inflation) will be adequate to meet his expenses. John's sustainable withdrawal rate is four percent, and he must make sure that his portfolio is designed so that he can continue to take out four percent (adjusted for inflation) each year.*

Other approaches to withdrawal rates

A performance-based withdrawal rate

With this approach, an initial withdrawal rate is established. However, if you prefer flexibility to a fixed rate, you might vary that percentage from year to year, depending on your portfolio's performance. Each year, you would set a withdrawal percentage, based on the previous year's performance, that would determine the upcoming year's withdrawal. In years of poor performance, a portfolio's return might be lower than your target withdrawal rate. In that case, you would reduce the amount you take out of the portfolio the following year. Conversely, in a year when the portfolio exceeds your expectations and performance is above average, you can withdraw a larger amount.

Example(s): *Fred has a $2 million portfolio, and withdraws $80,000 (four percent) at the beginning of his first year of retirement to help pay living expenses. By the end of that year, the remaining portfolio balance has returned six percent, or $115,200--more* *than the $80,000 he spent on living expenses. For the upcoming year, Fred decides to withdraw five percent of his portfolio, which is now worth $2,035,200 ($2 million - $80,000 + $115,200 = $2,035,200). That will give him $101,760 in income for the year, and leave his portfolio with $1,933,440. However, during December of that second year of retirement, his portfolio experiences a seven percent loss; by the end of the year, the portfolio has been reduced by the $101,7600 Fred withdrew at the beginning of the year, plus the seven percent investment loss. Fred's portfolio is now worth $1,798,099. Fred reduces his withdrawals next year--the third year of his retirement--to ensure that he doesn't run out of money too soon. (For simplicity's sake, this hypothetical illustration does not take taxes in account, and assumes all withdrawals are made at the beginning of the year.)*

Caution: *If you hope to withdraw higher amounts during good years, you must be certain that you'll be able to reduce your spending appropriately during years of lower returns; otherwise, you could be at greater risk of exhausting your portfolio too quickly. And be sure to take inflation into account. Having other sources of reliable, fixed income could make it easier to cushion potential income fluctuations from a performance-based withdrawal rate, and handle emergencies that require you to spend more than expected.*

A withdrawal rate that decreases or increases with age

Some strategies assume that expenses in the later years of retirement will be lower as a retiree becomes less active. They are designed to provide a higher income while a retiree is healthy and able to do more.

Example(s): *Bill sets a six percent initial withdrawal rate for his portfolio. However, he anticipates reducing that percentage gradually over time, so that in 20 years, he'll take only about three percent each year from his portfolio.*

Caution: *Assuming lower future expenses could have disastrous consequences if those forecasts prove to be wrong--for example, if health care costs increase even more sharply than they have in the past, or if a financial emergency late in life requires unplanned expenditures. Even assuming no future financial emergencies and no unexpected increases in the inflation rate, this strategy would require discipline on a retiree's part to reduce spending later, which might be difficult for someone accustomed to a higher standard of living.*

Other strategies take the opposite approach, and assumes that costs such as health care will be higher in the later retirement years. These set an initial withdrawal rate that is deliberately low to give the portfolio more flexibility later. The risk, of course, is that a retiree who dies early will leave a larger portion of his or her retirement savings unused.

Consider the impact of inflation

An initial withdrawal rate of, say, four percent may seem relatively low, particularly if you have a large portfolio. However, if your initial withdrawal rate is too high, it can increase the chance that your portfolio will be exhausted too quickly. That's because you'll need to withdraw a greater amount of money each year from your portfolio just to keep up with inflation and preserve the same purchasing power over time. For a retirement portfolio, that can become problematic, since the amount withdrawn is no longer available to generate income in future years. An appropriate initial withdrawal rate takes into account that inflation will require higher withdrawals in later years.

Example(s): *Jean has a $1 million portfolio invested in a money market account that yields five percent. That gives her $50,000 of income that year. However, inflation pushes up prices by three percent over the course of the year. That means Jean will need more income--$51,500--the next year just to cover the same expenses ($50,000 x.03=$1,500). Since the account provides only $50,000 of income, the additional $1,500 must be withdrawn from the principal. That principal reduction, in turn, reduces the portfolio's ability to produce income the following year. In a straight linear model, principal reductions accelerate, ultimately resulting in a zero portfolio balance after 25 to 27 years, depending on the timing of the withdrawals. (This example is a hypothetical illustration and does not account for the impact of any taxes.)*

Inflation is one reason you can't simply base your retirement income planning on the expenses you expect to have when you first retire. Costs for the same items will most likely continue to increase over your retirement years, and your initial withdrawal rate needs to take that into account to be sustainable.

There's another inflation-related factor that can affect your planning. Seniors can be affected somewhat differently from the average person by inflation. That's because costs for some services that may represent a disproportionate share of a senior's budget, such as health care and food, have risen more dramatically than the Consumer Price Index (CPI)--the basic inflation measure--for several years. As a result, seniors may experience higher inflation costs than younger people, and therefore might need to keep initial withdrawal rates relatively modest.

What determines whether a withdrawal rate is sustainable?

- Your time horizon: The longer you will need your portfolio to last, the lower the initial withdrawal rate should be. The converse is also true (e.g., you may have health problems that suggest you will not need to plan for a lengthy retirement, allowing you to manage a higher withdrawal rate).
- Anticipated and historical returns from the various asset classes in your retirement portfolio, as well as its anticipated average annual return: Though past performance is no guarantee of future results, the way in which you invest your retirement nest egg will play a large role in determining your portfolio's performance, both in terms of its volatility and its overall return. That, in turn, will affect how much you can take out of the portfolio each year without jeopardizing its longevity.
- Assumptions about market volatility: A financial downturn that reduces a portfolio's value, especially during the early years of withdrawal, could increase the need to use part of the principal for income. It could also require the sale of some assets, draining the portfolio of any future income those assets might have provided. Either of those factors could ultimately affect the sustainability of a portfolio's withdrawal rate.
- Anticipated inflation rates: Determining a sustainable withdrawal rate means making an assumption about changes in the cost of living, which will likely increase the amount you'll need the portfolio to provide each year to meet your expenses.
- The amounts you withdraw each year: When planning your retirement income, your anticipated expenses will obviously affect what you need to withdraw from your retirement portfolio, and therefore affect its sustainability. However, because this is one aspect over which you have at least some control, you may find that you must adjust your anticipated retirement spending in order to make your withdrawal rate sustainable over time.
- Any sources of relatively predictable income, such as Social Security, pension payments, or some types of annuity benefits: Having some stability from other resources may allow greater flexibility in planning withdrawals from your portfolio.
- Your individual comfort level with your plan's probability of success.

As with most components of retirement income planning, each of these factors affects the others. For example, projecting a longer lifespan will increase your need to reduce your withdrawals, boost your returns, or both, in order to make your withdrawal rate sustainable. And of course, if you set too high a withdrawal rate during the early retirement years, you may face greater uncertainty about whether you will outlive your savings.

Example(s): *Mary's financial professional tells her that given her current withdrawal rate and asset allocation strategy, there is an 80 percent chance that her retirement savings will last until she's 95 years old. Mary has several choices. If she wants to increase her confidence level--maybe she prefers a 95 percent chance of success--she might reduce her yearly spending, try to increase her portfolio's return by changing her asset allocation, direct a portion of her portfolio into an investment that offers a guaranteed lifetime income, or some combination. On the other hand, if she's a risk taker and is comfortable with having only a 75 percent chance that her portfolio will last throughout her lifetime, she might decide to go ahead and spend a bit more now. (This is a hypothetical illustration only, not financial advice).*

Income-only withdrawals vs. income and principal

Many people plan to withdraw only the income from their portfolios, intending not to touch the principal unless absolutely necessary. This is certainly a valid strategy, and clearly enhances a portfolio's sustainability. However, for most people, it requires a substantial initial amount; if your portfolio can't produce enough income to meet necessary expenses, an income-only strategy could mean that you might needlessly deprive yourself of enjoying your retirement years as much as you could have done. A sustainable withdrawal rate can balance the need for both immediate and future income by relying heavily on the portfolio's earnings during the early years of retirement, and gradually increasing use of the principal over time in order to preserve the portfolio's earning power for as long as possible.

Planning to use both income and principal requires careful attention to all the factors mentioned above. Also, in establishing your strategy, you should consider whether you want to use up all of your retirement savings yourself or plan to leave money to heirs. If you want to ensure that you leave an estate, you will need to adjust your withdrawal rate accordingly.

Your decision about income versus income-plus-principal should balance the need for your portfolio to earn a return high enough to sustain withdrawals with the need for immediate income. That can provide a challenge when it comes to allocating your assets between income-oriented investments, and investments that have the potential for a higher return but involve greater volatility from year to year. You may need to think of your portfolio as different "buckets"--for example, one "bucket" for your short-term living expenses, another bucket that could replenish your expenses bucket as needed, and another bucket invested for the long term.

Estimating lifespan

In general, life expectancies have been increasing over the last century. Life probabilities at any age are listed on the Social Security Administration's Period Life Table, available under the Actuarial Publications section of its web site.

Tip: *Regularly updated longevity estimates are published in the National Center for Health Statistics' National Vital Statistics Reports.*

However, be aware that averages are not necessarily the best guide when determining how long an individual portfolio may need to last. By definition, many people will live beyond the average life expectancy for their age group, particularly those who have a family history of longevity. Also, average life expectancies don't remain static over an individual's lifetime; a 30-year-old may have an average life expectancy of 76, while a 76-year-old may have a life expectancy of 85.

Couples will need to consider both individuals' life expectancies when planning a sustainable withdrawal rate.

Establishing a comfort level with uncertainty

As noted previously, setting a sustainable withdrawal rate requires many assumptions and forecasts about what will happen in the future. Changing any of the variables may increase or decrease the level of certainty about whether your portfolio will last as long as you need it to. Increasing certainty about the outcome may require reducing your withdrawal rate or revising your investment strategy. Conversely, increasing your withdrawal rate, especially in the early years of retirement, may also increase the odds that your portfolio will be depleted during your lifetime.

The challenge is to balance all factors so that you have an acceptable level of certainty about the portfolio's longevity consistent with providing the level of income needed over your expected lifetime and the risk you're willing to take to provide it.

One increasingly common method for estimating the probability of success is the Monte Carlo simulation. This technique uses a computer program that takes information about your portfolio and proposed withdrawal strategy, and tests them against many randomly generated hypothetical returns for your portfolio, including best-case, worst-case, and average scenarios for the financial markets. Based on those aggregated possibilities, the program calculates your portfolio's probability of success. Monte Carlo simulations also allow you to revise assumptions about lifespan, withdrawal rates, and asset allocation to see how changing your strategy might affect your portfolio's chances. Though the process offers no guarantees, it does take into account potential fluctuations in your portfolio's year-to-year returns. The result is a more sophisticated analysis than simply establishing a withdrawal rate based on a constant rate of return on your investments over time.

Some retirement income strategies tackle the question of uncertainty by including not only income sources that pay variable amounts, but also sources that provide relatively fixed or stable income, or lifetime income that is guaranteed. Just remember that the purchasing power of any fixed payment amounts can be eroded over time by inflation.

Once you've established an initial withdrawal rate, you probably should revisit it from time to time to see whether your initial assumptions about rates of return, lifespan, inflation, and expenses are still accurate, and whether your strategy needs to be updated.

Conventional wisdom about withdrawal rates

The process of determining an appropriate withdrawal rate continues to evolve. As baby boomers retire and individual savings increasingly represent a larger share of retirement income, more research is being done on how best to calculate withdrawal rates.

A seminal study on withdrawal rates for tax-deferred retirement accounts (William P. Bengen, "Determining Withdrawal Rates Using Historical Data," *Journal of Financial Planning* , October 1994), looked at the annual performance of hypothetical portfolios that are continually rebalanced to achieve a 50-50 mix of large-cap (S&P 500 Index) common stocks and intermediate-term Treasury notes. The study took into account the potential impact of major financial events such as the early Depression years, the stock decline of 1937-1941, and the 1973-74 recession. It found that a withdrawal rate of slightly more than four percent would have provided inflation-adjusted income for at least 30 years. More recently, Bengen used similar assumptions to show that a higher initial withdrawal rate--closer to five percent--might be possible during the early, active years of retirement if withdrawals in later years grow more slowly than inflation.

Other studies have shown that broader portfolio diversification and rebalancing strategies can also have a significant impact on initial withdrawal rates. In an October 2004 study ("Decision Rules and Portfolio Management for Retirees: Is the 'Safe' Initial Withdrawal Rate Too Safe?," *Journal of Financial Planning*), Jonathan Guyton found that adding asset classes, such as international stocks and real estate, helped increase portfolio longevity (although these asset classes have special risks). Another strategy that Guyton used in modeling initial withdrawal rates was to freeze the withdrawal amount during years of poor portfolio performance. By applying so-called decision rules that take into account portfolio performance from year to year, Guyton found it was possible to have "safe" initial withdrawal rates above five percent.

A still more flexible approach to withdrawal rates builds on Guyton's methodology. William J. Klinger suggests that a withdrawal rate can be fine tuned from year to year using Guyton's methods, but basing the initial rate on one of three retirement profiles. For example, one person might withdraw uniform inflation-adjusted amounts throughout their retirement; another might choose to spend more money early in retirement and less later; and still another might plan to increase withdrawals with age. This model requires estimating the odds that the portfolio will last throughout retirement. One retiree might be comfortable with a 95 percent chance that his or her strategy will permit the portfolio to last throughout retirement, while another might need assurance that the portfolio has a 99 percent chance of lifetime success. The study ("Using Decision Rules to Create Retirement Withdrawal Profiles," *Journal of Financial Planning* , August 2007) suggests that this more complex model might permit a higher initial withdrawal rate, but it also means the annual income provided is likely to vary more over the years.

Don't forget that all these studies are based on historical data about the performance of various types of investments, and past results don't guarantee future performance.

Market volatility and portfolio longevity

When setting an initial withdrawal rate, it's important to take a portfolio's volatility into account. The need for a relatively predictable income stream in retirement isn't the only reason for this. According to several studies in the late 1990s by Philip L. Cooley, Carl M. Hubbard, and Daniel T. Walz, the more dramatic a portfolio's fluctuations, the greater the odds that the portfolio might not last as long as needed. If it becomes necessary during market downturns to sell some assets in order to continue to meet a fixed withdrawal rate, selling at an inopportune time could affect a portfolio's ability to generate future income. And a steep market downturn, or having to sell assets to meet unexpected expenses during the early years of retirement, could magnify the impact of either event on your portfolio's longevity because the number of years over which those investments could potentially have produced income would be greater.

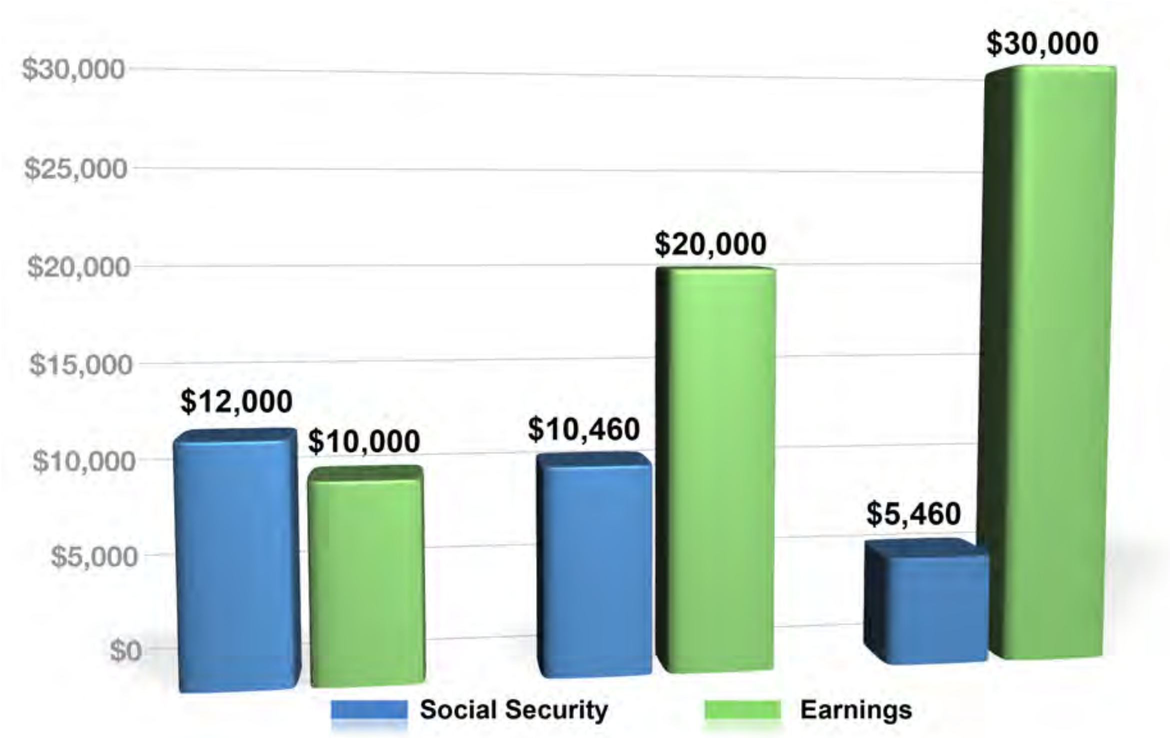
Withdrawal rates and tax considerations

When calculating a withdrawal rate, don't forget the tax impact of those withdrawals. For example, your withdrawal rates may need to cover any taxes owed on that money. Depending on your strategy for providing income, you could owe capital gains taxes or ordinary income taxes. Also, if you are selling investments to maintain a uniform withdrawal rate, the tax impact of those sales could affect your withdrawal strategy. Minimizing the tax consequences of securities sales or withdrawals from tax-advantaged retirement savings plans could also help your portfolio last longer.

How Earnings Affect Social Security

If you begin to receive Social Security retirement (or survivor's) benefits before you reach full retirement age, money you earn over a certain limit will reduce the amount of your Social Security benefit. In 2017, your benefit will be reduced by $1 for every $2 of earnings in excess of $16,920.*

The chart below shows the effect of annual earnings of $10,000, $20,000 and $30,000 on a $12,000 annual Social Security benefit ($1,000 monthly) for someone who hasn't yet reached full retirement age.



Source: Social Security Administration, 2016

*Special rules apply in both the year you reach full retirement age and the year you retire if you have not reached full retirement age.

Understanding Social Security

Approximately 66 million people today receive some form of Social Security benefits, including retirement, disability, survivor, and family benefits. (Source: Fast Facts & Figures About Social Security, 2017) Although most people receiving Social Security are retired, you and your family members may be eligible for benefits at any age, depending on your circumstances.

How does Social Security work?

The Social Security system is based on a simple premise: Throughout your career, you pay a portion of your earnings into a trust fund by paying Social Security or self-employment taxes. Your employer, if any, contributes an equal amount. In return, you receive certain benefits that can provide income to you when you need it most--at retirement or when you become disabled, for instance. Your family members can receive benefits based on your earnings record, too. The amount of benefits that you and your family members receive depends on several factors, including your average lifetime earnings, your date of birth, and the type of benefit that you're applying for.

Your earnings and the taxes you pay are reported to the Social Security Administration (SSA) by your employer, or if you are self-employed, by the Internal Revenue Service. The SSA uses your Social Security number to track your earnings and your benefits.

You can find out more about future Social Security benefits by signing up for a *my* Social Security account at the Social Security website, www.ssa.gov, so that you can view your online Social Security Statement. Your statement contains a detailed record of your earnings, as well as estimates of retirement, survivor, and disability benefits. If you're not registered for an online account and are not yet receiving benefits, you'll receive a statement in the mail every year, starting at age 60. You can also use the Retirement Estimator calculator on the Social Security website, as well as other benefit calculators that can help you estimate disability and survivor benefits.

Social Security eligibility

When you work and pay Social Security taxes, you earn credits that enable you to qualify for Social Security benefits. You can earn up to 4 credits per year, depending on the amount of income that you have. Most people must build up 40 credits (10 years of work) to be eligible for Social Security retirement benefits, but need fewer credits to be eligible for disability benefits or for their family members to be eligible for survivor benefits.

Your retirement benefits

Your Social Security retirement benefit is based on your average earnings over your working career. Your age at the time you start receiving Social Security retirement benefits also affects your benefit amount. If you were born between 1943 and 1954, your full retirement age is 66. Full retirement age increases in two-month increments thereafter, until it reaches age 67 for anyone born in 1960 or later.

But you don't have to wait until full retirement age to begin receiving benefits. No matter what your full retirement age, you can begin receiving early retirement benefits at age 62. Doing so is sometimes advantageous: Although you'll receive a reduced benefit if you retire early, you'll receive benefits for a longer period than someone who retires at full retirement age.

You can also choose to delay receiving retirement benefits past full retirement age. If you delay retirement, the Social Security benefit that you eventually receive will be as much as 8 percent higher. That's because you'll receive a delayed retirement credit for each month that you delay receiving retirement benefits, up to age 70. The amount of this credit varies, depending on your year of birth.

Disability benefits

If you become disabled, you may be eligible for Social Security disability benefits. The SSA defines disability as a physical or mental condition severe enough to prevent a person from performing substantial work of any kind for at least a year. This is a strict definition of disability, so if you're only temporarily disabled, don't expect to receive Social Security disability benefits--benefits won't begin until the sixth full month after the onset of your disability. And because processing your claim may take some time, apply for disability benefits as soon as you realize that your disability will be long term.

Family benefits

If you begin receiving retirement or disability benefits, your family members might also be eligible to receive benefits based on your earnings record. Eligible family members may include:

- Your spouse age 62 or older, if married at least 1 year
- Your former spouse age 62 or older, if you were married at least 10 years
- Your spouse or former spouse at any age, if caring for your child who is under age 16 or disabled
- Your children under age 18, if unmarried
- Your children under age 19, if full-time students (through grade 12) or disabled
- Your children older than 18, if severely disabled

Each family member may receive a benefit that is as much as 50 percent of your benefit. However, the amount that can be paid each month to a family is limited. The total benefit that your family can receive based on your earnings record is about 150 to 180 percent of your full retirement benefit amount. If the total family benefit exceeds this limit, each family member's benefit will be reduced proportionately. Your benefit won't be affected.

Survivor benefits

When you die, your family members may qualify for survivor benefits based on your earnings record. These family members include:

- Your widow(er) or ex-spouse age 60 or older (or age 50 or older if disabled)
- Your widow(er) or ex-spouse at any age, if caring for your child who is under 16 or disabled
- Your children under 18, if unmarried
- Your children under age 19, if full-time students (through grade 12) or disabled
- Your children older than 18, if severely disabled
- Your parents, if they depended on you for at least half of their support

Your widow(er) or children may also receive a one-time $255 death benefit immediately after you die.

Applying for Social Security benefits

The SSA recommends apply for benefits online at the SSA website, but you can also apply by calling (800) 772-1213 or by making an appointment at your local SSA office. The SSA suggests that you apply for benefits three months before you want your benefits to start. If you're applying for disability or survivor benefits, apply as soon as you are eligible.

Depending on the type of Social Security benefits that you are applying for, you will be asked to furnish certain records, such as a birth certificate, W-2 forms, and verification of your Social Security number and citizenship. The documents must be original or certified copies. If any of your family members are applying for benefits, they will be expected to submit similar documentation. The SSA representative will let you know which documents you need and help you get any documents you don't already have.

Closing a Retirement Income Gap

When you determine how much income you'll need in retirement, you may base your projection on the type of lifestyle you plan to have and when you want to retire. However, as you grow closer to retirement, you may discover that your income won't be enough to meet your needs. If you find yourself in this situation, you'll need to adopt a plan to bridge this projected income gap.

Delay retirement: 65 is just a number

One way of dealing with a projected income shortfall is to stay in the workforce longer than you had planned. This will allow you to continue supporting yourself with a salary rather than dipping into your retirement savings. Depending on your income, this could also increase your Social Security retirement benefit. You'll also be able to delay taking your Social Security benefit or distributions from retirement accounts.

At normal retirement age (which varies, depending on the year you were born), you will receive your full Social Security retirement benefit. You can elect to receive your Social Security retirement benefit as early as age 62, but if you begin receiving your benefit before your normal retirement age, your benefit will be reduced. Conversely, if you delay retirement, you can increase your Social Security benefit.

Remember, too, that income from a job may affect the amount of Social Security retirement benefit you receive if you are under normal retirement age. Your benefit will be reduced by $1 for every $2 you earn over a certain earnings limit ($17,040 in 2018, up from $16,920 in 2017). But once you reach normal retirement age, you can earn as much as you want without affecting your Social Security retirement benefit.

Another advantage of delaying retirement is that you can continue to build tax-deferred (or in the case of Roth accounts, tax-free) funds in your IRA or employer-sponsored retirement plan. Keep in mind, though, that you may be required to start taking minimum distributions from your qualified retirement plan or traditional IRA once you reach age 70½, if you want to avoid harsh penalties.

And if you're covered by a pension plan at work, you could also consider retiring and then seeking employment elsewhere. This way you can receive a salary and your pension benefit at the same time. Some employers, to avoid losing talented employees this way, are beginning to offer "phased retirement" programs that allow you to receive all or part of your pension benefit while you're still working. Make sure you understand your pension plan options.

Spend less, save more

You may be able to deal with an income shortfall by adjusting your spending habits. If you're still years away from retirement, you may be able to get by with a few minor changes. However, if retirement is just around the corner, you may need to drastically

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change your spending and saving habits. Saving even a little money can really add up if you do it consistently and earn a reasonable rate of return. Make permanent changes to your spending habits and you'll find that your savings will last even longer. Start by preparing a budget to see where your money is going. Here are some suggested ways to stretch your retirement dollars:

- Refinance your home mortgage if interest rates have dropped since you took the loan.
- Reduce your housing expenses by moving to a less expensive home or apartment.
- Sell one of your cars if you have two. When your remaining car needs to be replaced, consider buying a used one.
- Access the equity in your home. Use the proceeds from a second mortgage or home equity line of credit to pay off higher-interest-rate debts.
- Transfer credit card balances from higher-interest cards to a low- or no-interest card, and then cancel the old accounts.
- Ask about insurance discounts and review your insurance needs (e.g., your need for life insurance may have lessened).
- Reduce discretionary expenses such as lunches and dinners out.

Earmark the money you save for retirement and invest it immediately. If you can take advantage of an IRA, 401(k), or other tax-deferred retirement plan, you should do so. Funds invested in a tax-deferred account may grow more rapidly than funds invested in a non-tax-deferred account.

Reallocate your assets: consider investing more aggressively

Some people make the mistake of investing too conservatively to achieve their retirement goals. That's not surprising, because as you take on more risk, your potential for loss grows as well. But greater risk also generally entails potentially greater reward. And with life expectancies rising and people retiring earlier, retirement funds need to last a long time.

That's why if you are facing a projected income shortfall, you may want to consider shifting some of your assets to investments that have the potential to substantially outpace inflation. The amount of investment dollars you might consider keeping in growth-oriented investments depends on your time horizon (how long you have to save) and your tolerance for risk. In general, the longer you have until retirement, the more aggressive you can typically afford to be. Still, if you are at or near retirement, you may want to keep some of your funds in growth-oriented investments, even if you decide to keep the bulk of your funds in more conservative, fixed-income investments. Get advice from a financial professional if you need help deciding how your assets should be allocated.

And remember, no matter how you decide to allocate your money, rebalance your portfolio periodically. Your needs will change over time, and so should your investment strategy. Note: Rebalancing may carry tax consequences. Asset allocation and diversification cannot guarantee a profit or insure against a loss. There is no guarantee that any investment strategy will be successful; all investing involves risk, including the possible loss of principal.

Accept reality: lower your standard of living

If your projected income shortfall is severe enough or if you're already close to retirement, you may realize that no matter what measures you take, you will not be able to afford the retirement lifestyle you've dreamed of. In other words, you will have to lower your expectations and accept a lower standard of living.

Fortunately, this may be easier to do than when you were younger. Although some expenses, like health care, generally increase in retirement, other expenses, like housing costs and automobile expenses, tend to decrease. And it's likely that your days of paying college bills and growing-family expenses are over.

Once you are within a few years of retirement, you can prepare a realistic budget that will help you manage your money in retirement. Think long term: Retirees frequently get into budget trouble in the early years of retirement, when they are adjusting to their new lifestyles. Remember that when you are retired, every day is Saturday, so it's easy to start overspending.

Your Home as a Source of Dollars in Retirement

If you own a home, you may be wealthier than you think. The equity in your home could be one of your largest assets, especially if your mortgage has been paid down over the years or paid off. This home equity can be a valuable source of extra income during your retirement years.

How do you tap your home equity?

There are two ways to tap your home equity if you're approaching retirement (or already retired) and don't want to make mortgage payments: You can trade down, or you can use a reverse mortgage. Trading down involves selling your present home and replacing it with a smaller, less expensive home. A reverse mortgage is a home mortgage in which the lender makes monthly payments to you, rather than you making monthly payments to the lender. Both of these strategies can give you substantial additional income during retirement.

Note: You could get money from your home by taking a home equity loan, where you place a regular mortgage on your home. But you must repay the home equity loan, with interest, like other regular home mortgages.

Trading down can give you increased income

If your home is larger than you need, trading down to a smaller place may be a good way to increase your retirement income. The difference between the price that you receive for your present home and the cost of a smaller new home can be added to your retirement funds to provide you with additional investment income. The amount of cash that you can get by trading down depends on the value of your present home, the cost of purchasing a new home, and the incidental costs involved in the trade (e.g., brokerage commissions, legal fees, closing costs, and moving expenses). You should estimate these amounts to get some idea of the net amount that you will receive. To check the present value of your home, you should get an estimate of its selling price from two or three real estate agents. You should also get an estimate of the cost of your replacement home by shopping around for the type of home that you think you'll want.

Note: If you think that the tax consequences of trading down are a drawback, think again. You may be able to exclude from federal taxation up to $250,000 ($500,000 if you're married and file a joint return) of any resulting capital gain, regardless of your age. To qualify for this exclusion, you generally must have owned and used the home as your principal residence for a total of two out of the five years before the sale. An individual, or either spouse in a married couple, can generally use this exemption only once every two years. However, even if you don't meet these tests, a partial exemption may be available. (For sales and exchanges made after December 31, 2008, this homesale exclusion won't apply to the extent the gain is allocated to periods (not including any period before January 1, 2009) during which the property was not used as your, or your spouse's, principal residence.)

Trading down can reduce your housing costs

The other important financial benefit of trading down is that it reduces housing costs--often substantially. A smaller home usually means lower real estate taxes and smaller bills for heating, cooling, insurance, and maintenance costs. If your move is from a single-family house to a condominium, your costs will be reduced even more because outside painting, roof repair, landscaping, and similar costs disappear into lower monthly condo fees. You should carefully estimate the amount of the cost savings that you'll get from trading down. Compare the annual cost of maintaining your present home with the expected annual cost of maintaining your new home. Be sure to prorate expenses that do not occur regularly, such as indoor and outdoor painting and roof repairs.

But trading down may have disadvantages

Consider the possible drawbacks of trading down. For instance, you may not want to reduce your living space by moving to a smaller home. Or, you may not be able to find a smaller home as attractive as your present home. Another common problem with trading down occurs if you are strongly attached to your present home. You may not want to be uprooted from your home and the social network around it. Still, you may also be troubled by worries that afflict many older homeowners, such as rising property taxes, the threat of escalating insurance, and the unexpected cost of major repairs. You may decide that trading down is warranted to lighten these worries as well as your financial burden.

Note: If you sell your home at a gain and aren't eligible for the capital gain homesale exclusion, you'll have to pay federal income taxes on the difference between the selling price and your adjusted basis (the initial cost of your home, plus amounts you've paid for capital improvements, less any depreciation and casualty losses claimed for tax purposes) in the home.

A reverse mortgage can also give you increased income

If you are older and have substantial equity in your home, a reverse mortgage can give you a valuable supplemental source of retirement income. You can receive this income based on the equity that you have built up over the years in your home--without having to repay the reverse mortgage during your life. The amount of the monthly payment you receive from a reverse mortgage depends on four factors:

- Your age
- The amount of equity in your home
- The interest rate charged by the lender
- Closing costs

The older you are and the more the equity in your home, the larger your monthly payments will be. Also, a lower interest rate and lower closing costs will increase your payments.

A reverse mortgage lets you keep your present home for life

As discussed, you may not want to trade down for a variety of reasons, including attachment to your present home. With a reverse mortgage, you can increase your income and continue to live in your present home for life. The mortgage typically becomes due when you no longer live in the home.

When reverse mortgage payments last as long as you live in your home, the mortgage is known as a tenure reverse mortgage. You can get other types of reverse mortgages, including an annuity advance reverse mortgage. With the annuity mortgage, payments last as long as you live, regardless of whether you continue to live in your home.

But a reverse mortgage is not without drawbacks

With a reverse mortgage, you must mortgage your home to the lender. Each payment that you receive from the lender increases the amount of principal and interest that you owe on the mortgage. Although the mortgage typically does not become due while you're still living in the home, the equity value of your home is reduced by each payment that you receive. This reduction in the equity value of your home may have a negative effect on your children's ultimate inheritance.

Note: If you face a retirement income shortage, this equity reduction may be preferable to a reduction in your standard of living. Also, in the rare case where the value of your home appreciates more rapidly than the mortgage loan increases, equity reduction does not occur.

A reverse mortgage may have other drawbacks, including:

- High up-front costs: The closing costs for a reverse mortgage normally exceed the closing costs for a conventional mortgage. This means that a reverse mortgage may not be cost effective if you plan to remain in your home for only a few years.
- No reduction in homeowner costs: Unlike trading down to a home with lower housing expenses, a reverse mortgage does not reduce your housing costs. Since you stay in your home, you still face real estate taxes, insurance, repairs, and other costs associated with the home.

IRA and Retirement Plan Distributions

What is it?

IRAs and employer-sponsored retirement plans (e.g., 401(k) and profit-sharing plans) play a central role in retirement planning. After all, the tax benefits are hard to beat. With traditional IRAs and most employer-sponsored retirement plans, pre-tax money is contributed and grows tax deferred. It's not until you take funds out of the account that you pay income tax on the distributions. With Roth IRAs and Roth 401(k)/403(b)/457(b)s, the money that you contribute comes from after-tax dollars, and qualifying distributions are completely income tax free.

But to get the tax advantages of IRAs and retirement plans, you need to be familiar with the complicated distribution restrictions, requirements, and tax rules that apply to these retirement investments. At their most basic level, the IRS rules try to discourage you from receiving retirement funds too early or from leaving the funds in a tax-deferred plan or account for too long.

Options for taking distributions from employer-sponsored retirement plans and IRAs

Employer-sponsored retirement plans

In general, the Internal Revenue Code and IRS regulations determine the distribution options that are available under employer-sponsored retirement plans. However, employers are not required to offer all of the available distribution options in their plans. Therefore, it is important that you review the specific terms of your plan to see which options are available to you. These provisions normally include a lump-sum distribution of your entire balance under certain conditions, an annuity payout after separation from service, and a rollover to an IRA or another employer's plan. Other distribution options may also be available upon your termination of employment, upon your death, or even while you are still employed.

Whether taxes are due on distributions depends on whether pre-tax or after-tax contributions have been made. Where funds have not been previously taxed, they are generally taxed upon distribution.

Employer contributions, employee pre-tax contributions, and earnings are generally taxed as income when withdrawn from the plan (subject to certain exceptions, such as tax-free rollovers). An additional 10% premature distribution penalty may also be assessed on taxable portion of distributions taken from the plan prior to age 59½ (subject to certain exceptions).

Special rules apply to after-tax Roth 401(k)/403(b)/457(b) contributions. These contributions are free from federal income tax when paid to you from the plan and, if certain conditions are met (a "qualified distribution"), all investment earnings on these contributions are also tax free and penalty free when paid to you.

IRAs

IRA distributions can be made purely at the IRA owner's discretion. The taxation of distributions from IRAs depends on the type of IRA (traditional or Roth), the source of the contributions (pre-tax or after-tax), and whether all tax requirements have been met.

With traditional IRAs, distributions taken from the account may or may not be taxable income. Distributions of contributions are generally taxable only if they were tax deductible at the time you made them. Amounts you contributed that weren't eligible for a tax deduction (after-tax contributions) can generally be withdrawn income tax free (because tax has already been paid on those dollars). By contrast, distributions of investment earnings from these accounts are always taxable.

Your age is also a key factor in terms of the tax consequences and advisability of withdrawing IRA funds. That's because a 10% premature distribution tax applies to the taxable portion of IRA distributions taken prior to age 59½ (subject to certain exceptions).

Roth IRAs are subject to special rules. Your Roth IRA contributions are free from federal income tax when paid to you from your account and, if certain conditions are met (a "qualified distribution"), all investment earnings on these contributions are also tax free and penalty free when paid to you.

Designating a beneficiary for your IRA or retirement plan

If you have a traditional IRA or participate in an employer-sponsored retirement plan, carefully consider your choice of beneficiary. Your beneficiary will receive the money in your IRA or plan when you die. Your choice of beneficiary can determine (1) the tax deferral and distribution timing options available to your beneficiary and (2) whether the funds will be taxed in your estate for death tax purposes.

Caution: *Because Roth IRAs are unique, the considerations regarding beneficiary designations for Roth IRAs are unique as well.*

Inherited IRAs and employer-sponsored retirement plans

If you have inherited an IRA or retirement plan account, you need to be aware of the available options for taking or deferring distributions. With traditional IRAs and retirement plans, you usually have to pay income tax on the funds that you receive. Rather than simply taking all of the money from the IRA or plan at once (and paying tax on the lump-sum distribution), you may be able to defer and delay distributions from an inherited account (or plan) for a period of time, letting the dollars continue to grow tax deferred. The terms of the IRA or retirement plan will govern the distribution options available to you.

Estimating Your Social Security Benefits

What is estimating your Social Security benefits?

Estimating your Social Security benefits is particularly important when you are planning for retirement, although you may be interested in estimating survivor benefits or disability benefits as well. When planning for retirement, you should neither overlook nor overstate the value of your Social Security benefits. Predicting the future of Social Security is difficult, because to keep the system solvent, some changes must be made to it. The younger and wealthier you are, the more likely that these changes will affect you. But even if you retire in the next few years, remember that Social Security was never meant to be the sole source of income for retirees. As President Dwight D. Eisenhower said: "The system is not intended as a substitute for private savings, pension plans, and insurance protection. It is, rather, intended as the foundation upon which these other forms of protection can be soundly built." Estimating your Social Security benefits now will not only help you plan an effective long-term retirement strategy, but it can also help you understand what benefits might protect your family if you were to die or become disabled.

Obtaining a benefits estimate

You can estimate your retirement benefit online based on your actual earnings record using the Retirement Estimator calculator on the Social Security website, ssa.gov. You can create different scenarios based on current law that will illustrate how different earnings amounts and retirement ages will affect the benefit you receive. Other benefit calculators are also available that can help you estimate disability and survivor benefits. You can also sign up to view your Social Security Statement that contains a detailed record of your earnings, as well as estimates of retirement, survivor, and disability benefits. If you're not registered for an online account and are not yet receiving benefits, you'll receive a statement in the mail every year, starting at age 60.

Understanding how your benefit amount is calculated

Your Social Security benefits will be based on your average lifetime earnings, expressed as your primary insurance amount (PIA). Calculating your PIA is complicated because some factors used in the benefit formula change annually. To simplify the calculation, as well as make it more accurate, it might be helpful to obtain a benefit estimate directly from the SSA (see preceding section).

However, knowing how your PIA is calculated may be useful in benefit planning. Currently, the two PIA calculation methods most frequently used are:

1. The simplified old-start benefit method--This method is used if age 62, disability, or death occurred prior to 1979. It averages actual (not indexed) earnings and uses a table to calculate the PIA.
2. The wage indexing method--This method has been used since 1979. Indexing earnings is a way of adjusting them to reflect changes in wage levels throughout years of employment. This ensures that your benefits reflect increases in the standard of living. In general, the wage indexing method calculates your PIA by indexing your lifetime earnings up to and including the year you turn 59. Then, your highest earnings for a specific number of years (usually 35) are averaged and a benefit formula is applied to this figure to calculate the PIA.

Two other benefit computation methods are less frequently used:

1. "Special minimum" benefit tables are used sometimes to compute benefits payable to some individuals who have long periods of low earnings and who have at least 11 years of coverage.
2. Flat-rate benefits are provided to workers (and to their spouses or surviving spouses) who became age 72 before 1969 and who were not insured under the usual requirements.

How to calculate your PIA using the wage-indexing method

The wage indexing method can be used to calculate retirement, survivor's, and disability benefits. However, the method used to calculate disability benefits is slightly different. The following discussion applies only to calculating your PIA for retirement and death benefits.

Follow these steps to calculate your PIA:

- Count the number of years elapsed between 1951 (or the year you turned 22, if later) and the year you turned 61. If you were born in 1929 or later, this number will be 40.

Example(s): *Peter retired from his job in 1992. He was 62. He turned 22 in 1952, so count the number of years between 1952 and 1991 (the year he turned 61). Forty years have elapsed.*

- Use the number of elapsed years to determine the number of benefit computation years. To do this, subtract five from the number of computation elapsed years. This figure will be used to calculate your average indexed monthly earnings (AIME). If you were born in 1929 or later, this number will be 35.

Example(s): *Peter's computation elapsed year figure is 40. 40-5=35. So, Peter's benefit computation year figure is 35.*

- Use your earnings record to calculate your indexed earnings. To do this, use the appropriate table to determine what the indexing average wage was or will be in the year you turn 60. Then, look to see what the indexing average wage was in the year you are indexing. These figures become part of an indexing ratio applied to each year of earnings starting with 1951 and ending with the year you turn 59. (Earnings before 1951 are generally disregarded. Earnings in the year you turn 60 (your indexing year) and earnings in all later years are considered in calculating your PIA, but they are not indexed.) The indexing ratio can be expressed as the actual earnings in the year being indexed multiplied by the indexing average wage in the year you turned 60 divided by the indexing average wage in the year being indexed. The result will equal your indexed earnings for the year being indexed.

Example(s): *Peter started working in 1951 and retired in 1992. For each year starting with 1951 and ending with 1989 (the year he turned 59), calculate his indexed earnings. His indexing year is 1990 (the year he turned 60). For example, Peter's earnings in 1965 were $2,000. In 1965, the indexing average wage was $4,658.72. In 1990, the indexing average wage was $21,027.98. Calculate his 1965 indexed earnings:*

$2,000 multiplied by $21,027.98 divided by $ 4,658.72 = $9,027.36

Tip: *Actual earnings are earnings credited to an individual's Social Security record. However, each year's actual earnings are subject to a maximum earnings limit. If your earnings for the year you are indexing exceed the maximum limit, then you must substitute the maximum earnings limit amount for your actual earnings amount in the ratio.*

Example(s): *In 1965, the maximum earnings limit was $4,800. Had Peter's actual earnings exceeded that amount, he would have replaced his actual earnings figure in the ratio with $4,800 to calculate his indexed earnings for 1965.*

Once you have indexed your earnings for each year you have worked before age 60, you will be able to use those figures to calculate your average indexed monthly earnings (AIME).

- Calculate your AIME by selecting your highest earnings for the benefit computation years (including any earnings not subject to indexing). Add these up and divide by the total number of months elapsed during these years.

Example(s): *Peter had 39 years of indexed earnings and two years of earnings (1990 and 1991) not indexed but included in the calculation. Select his 35 highest earning years. The earnings for these years total $950,000. Divide this figure by 420 months (35 x 12). His AIME is $2261.90.*

- Calculate the PIA for the year you attain age 62 by applying percentages to certain dollar amounts of the AIME. The percentages are fixed, but the dollar amounts (called bend points) are adjusted each year for inflation.

Example(s): *Peter attained age 62 in 1992. His PIA would be calculated using 1992 bend points--90 percent of the first $387 of his AIME, and adding 32 percent of the AIME in excess of $387 through $2,333, and adding 15 percent of the AIME in excess of $2,333. So, Peter's PIA is calculated to be the sum of $348.30 (90 percent of $387) plus $599.65 (32 percent of $1,873.90) or $947.95, rounded to the next lower multiple of 10 cents, $947.90.*

Bend points make calculating your future PIA difficult because the bend points for each year are only published on or before November 1 of the preceding year. For 2018, the bend points are $895 and $5,397 ($885 and $5,336 for 2017).

- Adjust your PIA to account for changes in the cost-of-living allowance (COLA) yearly.

Example(s): *If Peter's PIA was $947.90 when he retired in October 1992, then his PIA was adjusted for COLA in December 1992, and his January 1993 benefit check reflected the change.*

Using your PIA to determine your benefit amount

Once the PIA has been calculated, all your benefits (and those of your family members who are dependent upon your Social Security record) will be based on this figure. Your PIA is the maximum benefit that you could receive once you become eligible.

Your maximum benefit may be payable if:

- You retire at full retirement age
- You are a widow or widower who is at least full retirement age
- You are a disabled worker

In other circumstances, the benefits that you receive will be a certain percentage of your maximum benefit. For example, if you elect to receive early retirement benefits, your maximum benefit will be reduced by a certain percentage for each month of early retirement. If you or your family members are eligible for reduced benefits, the reduction will be expressed as a percentage of your PIA.

Example(s): *Mr. Jones retired at age 65 (his full retirement age) after working for many years. His PIA was determined to be $1,176. He receives the maximum retirement benefit (100 percent of his PIA) so his monthly benefit check is $1,176. His wife retired at age 65 as well (her full retirement age). Since her own PIA was less, she decided to base her retirement income on her husband's PIA. She is entitled to 50 percent of his PIA, so she receives a monthly benefit check of $588.*

The following chart summarizes the relationship between your PIA and your eventual benefits:

Benefit	Requirements	Amount
Retirement	• Full retirement age • 62 or above, but less than full retirement age	• 100% of PIA • PIA reduced by 5/9 of 1% for each month under full retirement age, up to 36 months, and by 5/12 of 1% thereafter
Disability	• Not offset by other public disability benefits	• 100% of PIA
Spouse's benefit	• Caring for dependent child • Full retirement age • Age 62 or above, but less than full retirement age	• 50% of spouse's PIA further reduced by 25/36 of 1% for each of the first 36 months under full retirement age
Child's benefit	• Child of retired or disabled • Child of deceased worker	• 50% of worker's PIA • 75% of worker's PIA
Mother's or father's benefit	• Child must be under 16 or disabled	• 75% of deceased worker's PIA
Widow(er)'s benefit	• Full retirement age • Age 60 or above, but less than full retirement age	• 100% of deceased worker's PIA • Reduced; 71½% of deceased worker's PIA, or more
Disabled widow(er)'s benefit	• Starting at age 50-60	• 71½% of deceased worker's PIA
Parent's benefit	• One dependent parent • Two dependent parents	• 82½% of deceased worker's PIA • 75% of deceased worker's PIA (each)

Factors that can increase or decrease your benefit

Early retirement

If you elect to receive retirement benefits early (before full retirement age), your benefit will be reduced proportionately. You can elect to receive retirement benefits as early as age 62. For each month of early retirement, your total benefit will be reduced by 5/9 of 1 percent, up to 36 months, and by 5/12 of 1 percent thereafter. For example, if you elect to receive retirement benefits at age 62 and your full retirement age is 66, then you would receive approximately 25 percent less each month than you would at age 66.

Delayed retirement

If you delay receiving retirement benefits past full retirement age, you will receive a higher benefit when you retire. Late retirement may increase your average earnings (which may, in turn, increase your benefit). You will also receive a special delayed retirement credit. This credit is figured as a percentage of your Social Security benefit and is paid in addition to your regular benefit amount. It does not affect your PIA upon which your benefit is based.

This credit varies depending on the year in which you were born and how many months or years after full retirement age you retire (up to the maximum age of 70). For example, if you were born in 1944 (your full retirement age is 66), you will earn an extra 8 percent of your benefit for every year you delay retirement up to age 70. This means that if you delay receiving your retirement benefit until age 70, your benefit payment will be 32 percent greater than it would have been if you began receiving retirement benefits at age 66.

Earnings during retirement

Any income you earn after you retire must be reported to the Social Security Administration and may reduce your retirement benefit if you have not yet reached full retirement age. However, some of your annual earnings are exempt and won't affect your benefit.

Simultaneous benefits

Occasionally, you may be entitled to receive benefits based not only on your earnings record, but on someone else's as well. This often happens when a married couple retires.

Example(s): *Mr. Jones is not planning on retiring and receiving Social Security retirement benefits until he is 68. His PIA is $1,176. His wife, who is 63, wants to retire now, but she can't begin receiving a spouse's retirement benefit until her husband begins receiving his retirement benefits. However, since she is already over the age of 62, she can receive retirement benefits based on her own PIA. Her benefit, adjusted for early retirement, will be $400. Later, when her husband retires, she can receive her own retirement benefit and a spouse's benefit of $188, the difference between her own worker's benefit ($400) and the spouse's benefit she would have received based on 50 percent of her husband's PIA ($588).*

A family maximum benefit applies

Your family may receive benefits based on your earnings record. There is, however, a limit to the amount of monthly benefit that can be based on an individual's Social Security record. The limit varies but generally ranges from 150 to 180 percent of your PIA. Benefits to family members may be reduced if they exceed the family maximum. The formula used to compute the family maximum is similar to that used to compute the PIA.

Understanding IRAs

An individual retirement arrangement (IRA) is a personal savings plan that offers specific tax benefits. IRAs are one of the most powerful retirement savings tools available to you. Even if you're contributing to a 401(k) or other plan at work, you might also consider investing in an IRA.

What types of IRAs are available?

The two major types of IRAs are traditional IRAs and Roth IRAs. Both allow you to contribute as much as $5,500 in 2018 (unchanged from 2017). You must have at least as much taxable compensation as the amount of your IRA contribution. But if you are married filing jointly, your spouse can also contribute to an IRA, even if he or she has little or no taxable compensation, as long as your combined compensation is at least equal to your total contributions. The law also allows taxpayers age 50 and older to make additional "catch-up" contributions. These folks can contribute up to $6,500 in 2018 (unchanged from 2017).

Both traditional and Roth IRAs feature tax-sheltered growth of earnings. And both give you a wide range of investment choices. However, there are important differences between these two types of IRAs. You must understand these differences before you can choose the type of IRA that's best for you.

Note: Special rules apply to certain reservists and national guardsmen called to active duty after September 11, 2001.

Learn the rules for traditional IRAs

Practically anyone can open and contribute to a traditional IRA. The only requirements are that you must have taxable compensation and be under age 70½. You can contribute the maximum allowed each year as long as your taxable compensation for the year is at least that amount. If your taxable compensation for the year is below the maximum contribution allowed, you can contribute only up to the amount that you earned.

Your contributions to a traditional IRA may be tax deductible on your federal income tax return. This is important because tax-deductible (pre-tax) contributions lower your taxable income for the year, saving you money in taxes. If neither you nor your spouse is covered by a 401(k) or other employer-sponsored plan, you can generally deduct the full amount of your annual contribution. If one of you is covered by such a plan, your ability to deduct your contributions depends on your annual income (modified adjusted gross income, or MAGI) and your income tax filing status:

For 2018, if you are covered by a retirement plan at work, and:

- Your filing status is single or head of household, and your MAGI is $63,000 or less, your traditional IRA contribution is fully deductible. Your deduction is reduced if your MAGI is more than $63,000 and less than $73,000, and you can't deduct your contribution at all if your MAGI is $73,000 or more.

- Your filing status is married filing jointly or qualifying widow(er), and your MAGI is $101,000 or less, your traditional IRA contribution is fully deductible. Your deduction is reduced if your MAGI is more than $101,000 and less than $121,000, and you can't deduct your contribution at all if your MAGI is $121,000 or more.
- Your filing status is married filing separately, your traditional IRA deduction is reduced if your MAGI is less than $10,000, and you can't deduct your contribution at all if your MAGI is $10,000 or more.

For 2018, if you are not covered by a retirement plan at work, but your spouse is, and you file a joint tax return, your traditional IRA contribution is fully deductible if your MAGI is $189,000 or less. Your deduction is reduced if your MAGI is more than $189,000 and less than $199,000, and you can't deduct your contribution at all if your MAGI is $199,000 or more.

What happens when you start taking money from your traditional IRA? Any portion of a distribution that represents deductible contributions is subject to income tax because those contributions were not taxed when you made them. Any portion that represents investment earnings is also subject to income tax because those earnings were not previously taxed either. Only the portion that represents nondeductible, after-tax contributions (if any) is not subject to income tax. In addition to income tax, you may have to pay a 10% early withdrawal penalty if you're under age 59½, unless you meet one of the exceptions. You must aggregate all of your traditional IRAs — other than inherited IRAs — when calculating the tax consequences of a distribution.

If you wish to defer taxes, you can leave your funds in the traditional IRA, but only until April 1 of the year following the year you reach age 70½. That's when you have to take your first required minimum distribution from the IRA. After that, you must take a distribution by the end of every calendar year until you die or your funds are exhausted. The annual distribution amounts are based on a standard life expectancy table. You can always withdraw more than you're required to in any year. However, if you withdraw less, you'll be hit with a 50% penalty on the difference between the required minimum and the amount you actually withdrew.

Learn the rules for Roth IRAs

Not everyone can set up a Roth IRA. Even if you can, you may not qualify to take full advantage of it. The first requirement is that you must have taxable compensation. If your taxable compensation in 2018 is at least $5,500, you may be able to contribute the full amount. But it gets more complicated. Your ability to contribute to a Roth IRA in any year depends on your MAGI and your income tax filing status:

- If your filing status is single or head of household, and your MAGI for 2018 is $120,000 or less, you can make a full contribution to your Roth IRA. Your Roth IRA contribution is reduced if your MAGI is more than $120,000 and less than $135,000, and you can't contribute to a Roth IRA at all if your MAGI is $135,000 or more.
- If your filing status is married filing jointly or qualifying widow(er), and your MAGI for 2018 is $189,000 or less, you can make a full contribution to your Roth IRA. Your Roth IRA contribution is reduced if your MAGI is more than $189,000 and less than $199,000, and you can't contribute to a Roth IRA at all if your MAGI is $199,000 or more.
- If your filing status is married filing separately, your Roth IRA contribution is reduced if your MAGI is less than $10,000, and you can't contribute to a Roth IRA at all if your MAGI is $10,000 or more.

Your contributions to a Roth IRA are not tax deductible. You can invest only after-tax dollars in a Roth IRA. The good news is that if you meet certain conditions, your withdrawals from a Roth IRA will be completely income tax free, including both contributions and investment earnings. To be eligible for these qualifying distributions, you must meet a five-year holding period requirement. In addition, one of the following must apply:

- You have reached age 59½ by the time of the withdrawal
- The withdrawal is made because of disability
- The withdrawal is made to pay first-time home-buyer expenses ($10,000 lifetime limit)
- The withdrawal is made by your beneficiary or estate after your death

Qualified distributions will also avoid the 10% early withdrawal penalty. This ability to withdraw your funds with no taxes or penalties is a key strength of the Roth IRA. And remember, even nonqualified distributions will be taxed (and possibly penalized) only on the investment earnings portion of the distribution, and then only to the extent that your distribution exceeds the total amount of all contributions that you have made. You must aggregate all of your Roth IRAs — other than inherited Roth IRAs — when calculating the tax consequences of a distribution.

Another advantage of the Roth IRA is that there are no required distributions after age 70½ or at any time during your life. You can put off taking distributions until you really need the income. Or, you can leave the entire balance to your beneficiary without ever taking a single distribution. Also, as long as you have taxable compensation and qualify, you can keep contributing to a Roth IRA after age 70½.

Choose the right IRA for you

Assuming you qualify to use both, which type of IRA is best for you? Sometimes the choice is easy. The Roth IRA will probably be a more effective tool if you don't qualify for tax-deductible contributions to a traditional IRA. However, if you can deduct your traditional IRA contributions, the choice is more difficult. The Roth IRA may very well make more sense if you want to minimize taxes during retirement and preserve assets for your beneficiaries. But a traditional deductible IRA may be a better tool if you want to lower your yearly tax bill while you're still working (and probably in a higher tax bracket than you'll be in after you retire). A financial professional or tax advisor can help you pick the right type of IRA for you.

Note: You can have both a traditional IRA and a Roth IRA, but your total annual contribution to all of the IRAs that you own cannot be more than $5,500 for 2018 ($6,500 if you're age 50 or older).

Know your options for transferring your funds

You can move funds from an IRA to the same type of IRA with a different institution (e.g., traditional to traditional, Roth to Roth). No taxes or penalty will be imposed if you arrange for the old IRA trustee to transfer your funds directly to the new IRA trustee. The other option is to have your funds distributed to you first and then roll them over to the new IRA trustee yourself. You'll still avoid taxes and penalty as long as you complete the rollover within 60 days from the date you receive the funds.

You may also be able to convert funds from a traditional IRA to a Roth IRA. This decision is complicated, however, so be sure to consult a tax advisor. He or she can help you weigh the benefits of shifting funds against the tax consequences and other drawbacks.

Note: The IRS has the authority to waive the 60-day rule for rollovers under certain limited circumstances, such as proven hardship.

What if my income during retirement won't be enough to meet my retirement expenses?

Answer:

Fortunately, you may have no need to despair. The further you are from retirement, the more time you have to resolve the expected shortfall. Even if you are closing in on retirement, there may be steps you can take to bridge the gap.

In some cases, the best solution is to cut back current expenses and use that money toward retirement. This will enable you to put more money into your IRA, 401(k), and other retirement savings vehicles. Although you may not think you spend much on dining out and entertainment, such expenses really add up over time. Eliminating large purchases like boats and other luxury items will also make a big difference. Another way to save a bundle is to look into public colleges where your child can get a quality education for a fraction of what a private college costs.

But you might be unwilling to make such sacrifices. If so, or if you simply can't afford to save any more than you already are, consider investing more aggressively. Weight your portfolio more heavily toward stocks and growth mutual funds, and less toward fixed-income securities. A more aggressive investment portfolio exposes you to heightened volatility, but it may also provide a much greater return over the long run. The result: a potentially larger nest egg for you to draw on during retirement. *Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which are contained in the prospectus available from the fund. Review the prospectus carefully, including the discussion of fund classes and fees and how they apply to you.*

Another alternative is to lower your planned expenses during retirement by setting more modest goals. Instead of buying that beach mansion on the Riviera, settle for a smaller house a few miles from the ocean. Similarly, instead of taking expensive trips around the world on a regular basis, travel closer to home and less often. The idea of a more frugal retirement lifestyle may not appeal to you, but financial reality may require it.

You can take a variety of other steps to make sure that retirement income will at least keep pace with retirement expenses. Some of the most common: work part-time during retirement or simply put off retiring until you're in a better financial position. Consult your financial planner for further advice.

I'm retired now and own my home outright. How can I use it to raise money without selling it?

Answer:

You may want to consider a reverse annuity mortgage, more commonly known as a reverse mortgage. Developed to help the elderly find an additional source of income while remaining in their homes, reverse mortgages are steadily proliferating and in many instances are federally insured.

Generally speaking, reverse mortgages are offered at fixed rates of interest. (Federally insured Home Equity Conversion Mortgages are also offered at adjustable rates.) All parties to the deed must be 62 or older before you can qualify. When you apply, your lender appraises your property to determine how much equity is available for you to borrow against. The older you are at the time of your application, the larger the percentage of your equity you may access. Once this amount is determined, you may borrow against it through one of three types of reverse mortgages.

A tenure reverse mortgage pays you a designated sum of money each month. The payment amount depends on your age, the equity in your home, and the interest rate of the loan. As you receive your payments, both the principal balance and the interest owed on the loan grow. Accumulated principal and interest are repaid upon sale of the property, which may not occur (unless you choose to sell) until after the death of the last party to the mortgage. Thus, you can use a tenure reverse mortgage to supplement your monthly income indefinitely. You do not run the risk of being required to sell your home. However, the size of your estate will be reduced because you are continuously reducing the equity in your home.

A term reverse mortgage allows you to receive preset monthly payments for a specified length of time (the term of the mortgage). Generally, all other factors being equal, term reverse mortgages will give you larger monthly payments than do tenure reverse mortgages, simply because the term of the mortgage is fixed rather than indefinite. When the term is up, the loan must be repaid. This might be accomplished by refinancing your home with a conventional "forward" mortgage. If this is not possible, however, and you have no other means to repay the loan, you must sell your home to satisfy the reverse mortgage. Thus, you might want to consider a term reverse mortgage only if you plan to sell your home before the expiration of the term, and need money in the meantime for medical care or home repairs.

An equity line reverse mortgage allows you to take different lump-sum amounts of equity out of your home as desired or needed up to a predetermined maximum amount. Depending on the mortgage agreement, the principal amount you borrow, plus accumulated interest, may become due either at a preset future date (as with a term loan) or at an unspecified date (as with a tenure loan).

Are my Social Security benefits subject to income tax?

Answer:

A portion of your benefits may be subject to income tax if your modified adjusted gross income (MAGI), plus one-half your Social Security benefits, exceeds specific limits. Your MAGI equals:

- Adjusted gross income (or the adjusted gross income of you and your spouse if married and filing jointly), including wages, interest, dividends, taxable pensions, and other sources,
- Tax-exempt interest income (e.g., interest from municipal bonds and qualified U.S. savings bonds), and
- Amounts earned in a foreign country, U.S. possession, or Puerto Rico that are exempt from tax

Up to 50 percent of your Social Security benefits may be subject to income tax if your combined income (MAGI plus one-half your Social Security benefits) exceeds $25,000 for an individual filing single, unmarried head of household, or qualified widow(er) with dependent ($32,000 if married and filing jointly).

If your combined income exceeds $34,000 ($44,000 if married and filing jointly), up to 85 percent of your benefits is taxable. If you are married and filing separately, up to 85 percent of your benefits will be taxed unless you and your spouse live apart for the entire year.

Consult an accountant or other tax professional for more information. Or, contact the Internal Revenue Service at (800) 829-1040 or www.irs.gov. Ask for Publication 554, Tax Guide for Seniors, and Publication 915, Social Security and Equivalent Railroad Retirement Benefits.

Should I use my 401(k) to fund my child's college education?

You can, but it isn't your best option. Your 401(k) plan should be dedicated primarily to your retirement.

There are two primary drawbacks to using your 401(k) for college funding. First, if you withdraw funds from your 401(k) before you are 59½, you will owe a 10% premature distribution penalty on the withdrawal. This penalty is in addition to income taxes you will owe on the withdrawal. Second, frequent dips into your 401(k) reduce the amount of money you ultimately have available to reap the benefits of compounding and tax deferral. This, in turn, reduces the overall funds for your retirement.

If you really need to use your 401(k) funds to pay for college, a better option might be to borrow from your plan if your plan allows loans. Plan loans are not taxed or penalized, as long as you repay the funds within a specified time period. But make sure you compare the cost of borrowing college funds from your plan with other finance options. Although interest rates on plan loans may be favorable, the amount you can borrow is limited, and you generally must repay the loan within five years. In addition, some plans require you to repay the loan immediately if you leave your job. Your retirement earnings will also suffer as a result of removing funds from a tax-deferred investment.

If you want to save for college in a retirement vehicle, consider using a traditional IRA or Roth IRA instead. With IRAs, you will not owe a 10% premature distribution penalty on withdrawals you make before age 59½ if the money is used to pay your child's qualified college expenses.

Can I take money from my IRA without any penalty?

Answer:

It depends. If you are 59½ or older, you can take money from your traditional IRA without penalty. In contrast, if you withdraw from your IRA before age 59½, the taxable portion of your distribution may be subject to a 10 percent penalty on top of whatever income taxes you owe on the distribution. This penalty, known as the premature distribution tax, is intended to discourage people from exhausting their IRA funds before they retire.

However, there are some exceptions to this rule. Premature IRA withdrawals made by a disabled person may be exempt from the penalty. If an IRA owner dies before age 59½, distributions paid to you as a beneficiary of the account are not subject to the penalty. If you need supplementary income, you can take IRA distributions as a series of "substantially equal payments" over your life expectancy or the joint life expectancy of you and your beneficiary. These distributions will avoid the penalty as long as you don't modify the payments within certain time frames. Subject to limits and conditions, the penalty tax generally will not apply to IRA distributions taken to pay qualifying medical expenses, health insurance premiums while unemployed, higher education costs, and qualified first-time home-buyer expenses (up to $10,000 lifetime from all your IRAs). It also does not apply to amounts rolled over from one IRA to another (assuming you follow the rules for rollovers), to conversions of traditional IRAs to Roth IRAs, to amounts that the IRS levies from your IRA to cover your tax bill, or to qualified reservist distributions. Other exceptions may also apply.

Qualified distributions from your Roth IRAs are federal income tax--and penalty tax--free. Distributions are qualified if you satisfy a five-year holding period, and you are (a) age 59½, (b) disabled, (c) deceased, or (d) you have qualified first time home-buyer expenses. The taxable portion of nonqualified distributions from your Roth IRAs is subject to the same 10 percent penalty rules that apply to traditional IRAs. (Special rules may apply if you take a nonqualified distribution from your Roth IRA within five years of a conversion.)

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